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Enough on China

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- **U.S. Economic Momentum Remains Steady - Belated Homebuilding Growth Addition**
- **Softening China Trade Offset with European Recovery**
- **Fundamentals Still Support U.S. Rates Rise - Global Market Dependence on China Overdone**

The China factor has overwhelmed investor sentiment since its mini-devaluation. Despite its economic ranking, China has a more limited impact on global economics than pessimists recently assume and relatively minimal impact on the U.S. economy. Household spending still dominates U.S. GDP and residential construction spending is gathering momentum after an unusually slow recovery from the recession. Europe's economic momentum is accelerating as well. Despite market pullbacks, the case for U.S. interest rate normalization has not been fundamentally derailed, in our view, when a wider range of indicators is taken into account.

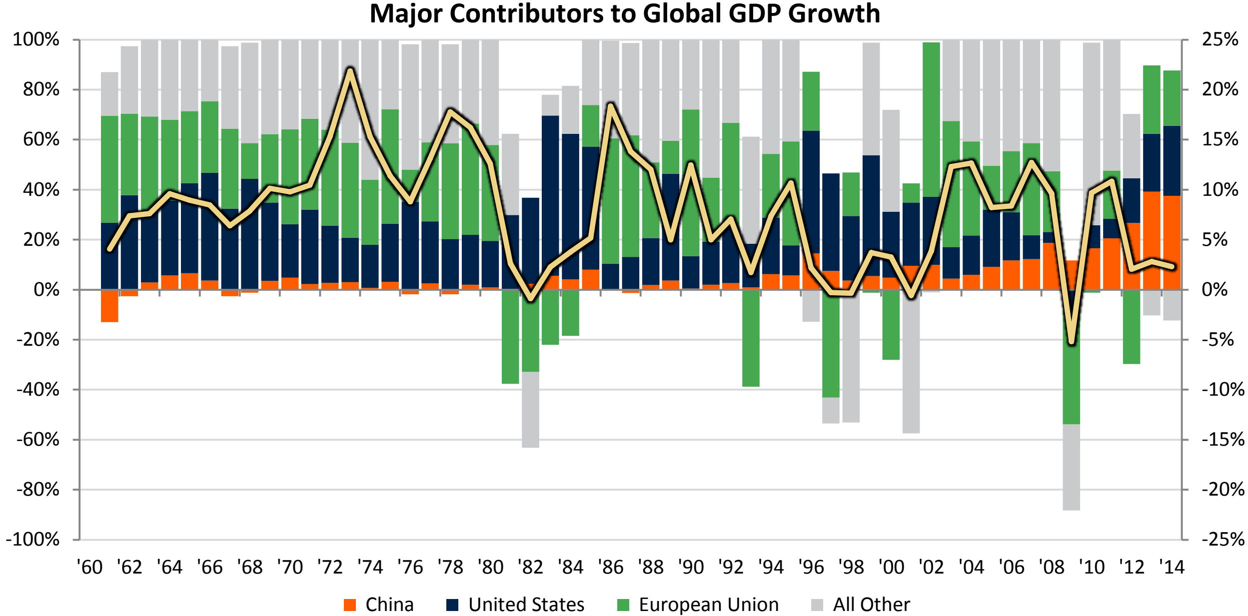
First, China is only 9% of global imports. The exhibit below illustrates China's impact on both global GDP and

Source: World Bank, IMF, Sandler O'Neill

imports. Too often, investors focus on China's recent outsized weight in year-over-year GDP growth, which in nominal terms can be shown to provide as much as half of the world's annual economic gain. When seen in this metric it is easy to conclude that as China goes, so must go the world. This is misleading in two ways. First, there

are many economies that have been declining, arithmetically boosting contributions from growing economies. Second, and far more important, GDP is a measure of internal - or domestic - growth and has little direct external impact. The more relevant measure of global impact is from imports. Imports reflect external demand to other economies, and here China's influence is much more modest. Although its contribution to global demand essentially tripled over the last decade, it peaked just over 10% and is currently only 9%.

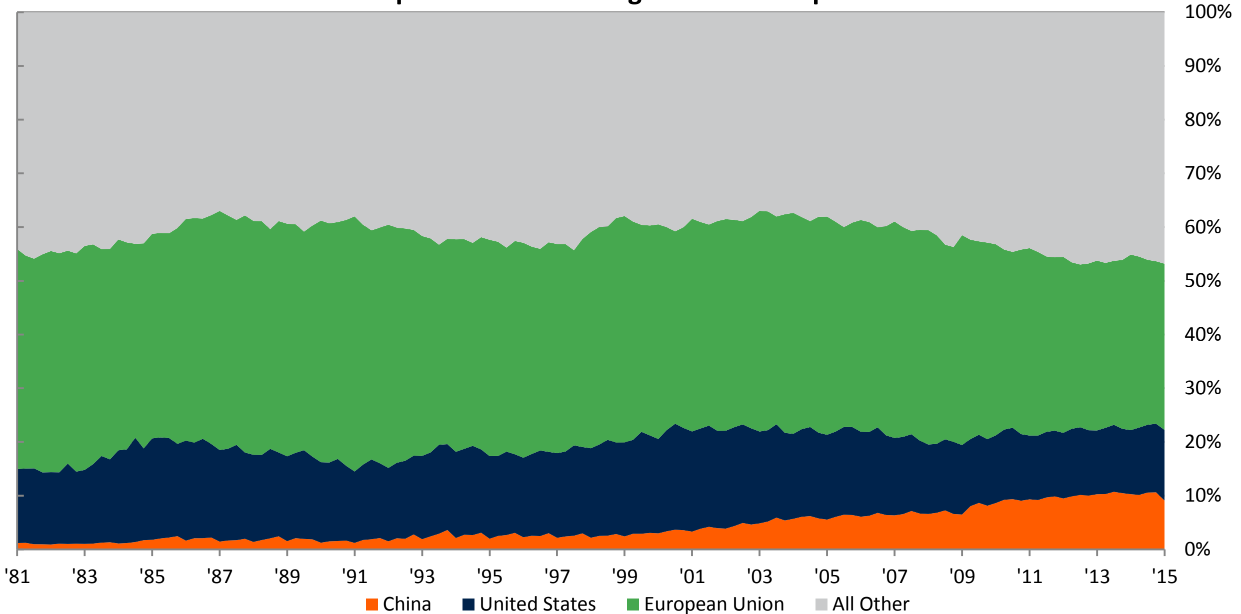
The following two exhibits help put China's GDP and imports in better global context. In the first graph, real GDP growth is shown in the solid line with the right scale. Contributions to this growth are shown in the bars with the left scale for China, Europe, U.S. and All Others. It is noteworthy that China's highest contributions occurred during the recent slowdown in global GDP growth.



Source: World Bank, Sandler O'Neill

The more relevant contribution to global imports is shown in the graph below. For the last five years China has roughly matched the U.S. level. But even with far slower economic growth the European Union is double both and is arguably the dominant single bloc to cross-border trade demand. Comfortingly, the most recent data reveals Europe in its second recovery since the 2008-2009 recession.

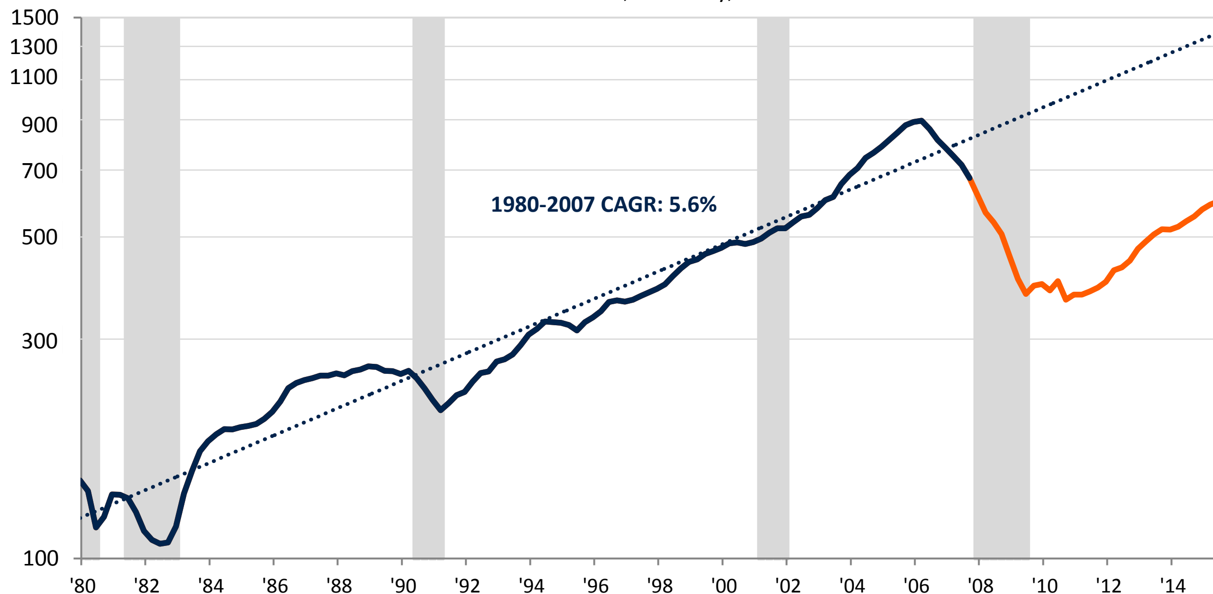
Importantly, China's GDP slowdown is the intentional result of its emphasis on domestic spending. In the long run this should build both a better domestic balance away from heavy reliance on investment and, ultimately, a stronger market for global import demand. To be fair, other Asian economies will experience weaker export demand during China's transition. This transition is overdue and critical for China.



Source: IMF, Sandler O'Neill

China ranks near the bottom on household spending at 36% of GDP. Among the top 22 countries that comprise 80% of global GDP, only Saudi Arabia is lower. South Korea is at 51% and Indonesia is at 57%. Europe's eight largest economies average 57%. Household spending in the largest Latin American economies average 60% and the U.S. is at 68%. We have frequently pointed out that the U.S. consumer spending cycle is no longer the vibrant driver it once was, largely due to demographic factors. It nonetheless acts effectively as "momentum ballast" as it holds to a more muted but steady 2% (real) growth trend.

While China transitions to a better balance of its GDP components, the U.S. economy is slowly transitioning in the opposite direction with less reliance on consumption and more toward investment. This has been clear from high single-digit growth in investment since the recession. Both transitions will likely occupy the next decade. Within U.S. fixed investment the residential construction element is finally gathering momentum. Up until now, residential construction has been lackluster - quite unusual for any post recessionary period as it is usually a leading driver during recoveries. While there were many reasons for this delayed reaction they are clearly waning and we suspect the catch-up phase will add thrust to overall fixed investment for several years.



The above exhibit highlights the magnitude of loss in homebuilding after 25 years of mid-single-digit growth. Private residential investment remained flat for two years after its collapse and is recovering from a low base. Many argue that the rental market has become more appropriate for both demographic and cultural reasons. With U.S. policy fixated on home ownership this may not last and even if there is a more permanent shift both multifamily and rental home market construction are likely to be strong.

Comparing apples to apples, but from different vendors, the annual rise in U.S. residential construction averaged $225 billion for the last three years and should maintain a similar level of gains for the next few years. This factor alone is approximately double the level of total U.S. exports to China.

Financial stocks - particularly bank stocks - were hit hard after the over-reaction to China's devaluation. The NASDAQ bank index remains off 7% from recent highs, only a little better than the S&P 500. Ostensibly the worry centers on a delay or diminution in prospective Fed interest rate hikes. To this concern we should point out that China must now spend some of its sizeable hard currency reserves to defend the renminbi, rather than spend them or buy government securities. It is estimated China's reserves are recently declining somewhere around $50 billion per month. The U.S. dollar component of that decline should be somewhere around $25 billion per month. In comparison net new supply of U.S. Treasuries at auction has been running about $50 billion per month. Through reinvestments China has kept its U.S. Treasuries holdings flat for some time. That is undoubtedly changing and will by itself put pressure on U.S. interest rates even without any Fed action.

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