Managing The Dragon’s 2018 China Predictions

In analyzing the events of 2017, it strikes *Managing The Dragon* (*MTD*) that many of the key variables surrounding China were interrelated to a degree that they have not been in years past. The independent variable in the equation seems to be the unexpected strength in China’s exports to the United States last year, which then had a knock-on effect on other variables. It may be amateurish economic and political analysis, but here is how *MTD* sees it.

Following a decline in 2016, China’s exports to the United States increased by an estimated 10 percent to over $500 billion in 2017. Given how closely supply chains in China are now integrated with customers and suppliers in the United States, it is not surprising that China’s exports to the United States began to tick up in the second quarter, just as the U.S. economy broke into 3 percent growth territory.

On the currency front, the *renminbi* opened 2017 at almost 7.0 to 1 due to weak exports and an alarming outflow of currency as a result of record overseas acquisitions by Chinese companies. In order to keep its currency stable and stem the outflow of capital, China began to curtail overseas acquisitions early in the year. After being weak for over one year, the yuan began to strengthen in May, reaching 6.48 to 1 by September as a result of capital inflows from greater exports, as well as the new restrictions on outbound mergers and acquisitions (“M&A”). Meanwhile, at year’s end, just when China’s exports to the United States reached an all-time record of $48 billion per month, signs began to appear that China was making good on its promise to reduce trade with North Korea. Were all of these events related and being driven at least in part by exceptionally strong U.S. exports? That certainly seems to be the case.

From the point of view of U.S. companies and investors, the direction of China’s currency; the level of overseas investment by Chinese companies; and the extent to which China might help to solve the North Korea problem are key questions going into 2018. *MTD* believes that 2018 will be another strong year for U.S. exports and that this strength will heavily influence China’s actions on other fronts, just as they seemed to do in 2017. If *MTD* is right, we may just run the table with our 2018 predictions. If we are wrong, we are likely to strike out on most of them.

Prediction #1: After exceptionally strong growth in 2017, China’s exports to the United States will once again break records in 2018.
By slashing the corporate tax rate to 21 percent, the tax bill promoted by the Trump Administration and passed by Congress at the end of 2017 was designed to bring home the trillions of dollars held offshore by U.S. companies and to spur investment and job growth at home. As evidenced by the recent announcements of companies like Apple, which said that it will spend over $350 billion in the United States over the next five years as a result of the tax cut, the bill seems to be having the desired effect.

As a result of continued deregulation, expanding gas exploration and other economic measures, the stock market, which is setting new records almost every day, seems to be saying that the U.S. economy will be stronger in 2018. Notable figures like **Jamie Dimon**, JPMorgan Chase & Co. CEO, concur. Dimon believes that economists predicting lower growth, including his own, are wrong and thinks that the U.S. economy might grow by as much as 4 percent in 2018.

Assuming that the United States does not impose across the board punitive tariffs on Chinese imports — which MTD considers unlikely given the need for China's cooperation on North Korea — China's exports to the United States are certain to grow further in 2018. *MTD*believes that the stage has been set for another record year for China's exports to its largest trading partner.

Prediction #2: China will maintain the value of the renminbi at approximately the current exchange rate of 6.5 to 1.

At the beginning of 2017, MTD's view was that all of the pressures on China's currency were on the downside, and therefore predicted a weaker yuan, trading in the range of 7.0 to 7.5 to 1 at the end of 2017. We were wrong. Instead, the yuan strengthened during the year to the current level of approximately 6.4 to 1.

Assuming that Prediction #1 holds and that exports to the United States experience another record year, China will be loath to allow the renminbi to weaken significantly. In the face of strong export growth and an "America First" administration in Washington, *MTD* believes that China's leaders are particularly sensitive to charges of currency manipulation and will do all in their power to keep the currency stable. 6.5 to 1 has been an acceptable exchange rate in recent years, and *MTD* believes that China will seek to stabilize the yuan at approximately this level in 2018.

Prediction #3: In the face of strong export growth, China will continue to restrict overseas investment. As a result, overseas acquisitions by Chinese companies will be flat to down in 2018.

Spurred by the desire on the part of Chinese companies to be global, as well as favorable government policies that encouraged Chinese companies to go abroad, overseas acquisitions by Chinese companies surged in 2016, and Chinese companies became important players in global M&A. Combined with weak exports, the heavy outflow of capital that resulted caused a significant weakening of the renminbi. In order to prop up its currency, China began dumping U.S. Treasuries at the end of 2016, using the dollars received to buy the yuan and draining the country's foreign currency reserves in the process.

To stem the capital outflow, China imposed restrictions on overseas investment, which it tightened as the year progressed. As a result, overseas M&A volume was down 39 percent in the first three quarters of 2017. Investment bankers will be disappointed, but *MTD* believes that China will continue to make it difficult for Chinese companies to make overseas acquisitions in 2018.

Prediction #4: The situation with North Korea will come to a head in 2018, and China will play a constructive role, albeit behind the scenes, in the successful resolution of the crisis on the Korean Peninsula.

MTD is going way out on a limb with this prediction.

By all accounts, North Korea is within months of being able to arm ICBMs with nuclear weapons. The Trump Administration is on record as saying that this is an unacceptable development, and the false alarms in both Hawaii and Japan this month demonstrated how nervous citizens in the United States and the rest of the world have become with this prospect. In a recent interview, **John Kelly**, Trump's Chief of Staff, said that, with respect to North Korea, the United States has kicked the can down the road for the past 25 years. "The problem at this point in time is there's no road left. We have to deal with this guy," Kelly concluded.

While pictures have appeared in the media of Chinese vessels secretly transferring oil to boats headed for North Korea in violation of U.N. sanctions, the numbers tell a different story. In December, the value of Chinese goods exported to North Korea fell 23 percent, while imports from the country plunged by 82 percent year on year. In total, trade between China and North Korea fell almost 51 percent during the month. For 2017 as a whole, China's overall trade with North Korea declined by more than 10 percent to about $5 billion. China has an important geopolitical stake in seeing that the crisis on the Korean Peninsula is resolved peacefully, and the economic stakes increase for China as the United States becomes an even more important trading partner.

MTD believes that China will work behind the scenes with the United States to achieve a peaceful resolution of the North Korean problem. A protective alliance between North Korea and China, the only country in the world that could credibly offer protection against regime change to Kim Jung Un, in exchange for denuclearization, would be one way that China could defuse the tensions on the Korean peninsula.

Prediction #5: China will break the 1.0 million mark in sales of New Energy Vehicles ("NEVs") in 2018. From 2013 to 2016, sales of NEVs in China increased from 17,642 to 507,000 units. Strong sales of NEVs continued in 2017 with a further 53 percent increase to 777,000 vehicles. While the NEV category in China includes electric vehicles (EVs) as well as plug-in hybrids, the vast majority of the units are EVs. Of the NEVs sold in China last year, approximately 74 percent were passenger cars and 26 percent were commercial vehicles, primarily buses.

The official numbers for China's auto sales in general, and NEV sales, in particular, do not include an estimated 1.0 million plus low-speed electric vehicles (LSEVs) that are used extensively in China's Tier 2 and Tier 3 cities, but that are not recognized by China's central government. Nonetheless, the production of LSEVs provide a much-needed transportation alternative to less affluent parts of the population and are supported by many of China's provincial governments. For these reasons, there are ongoing discussions regarding official recognition and the promulgation of specific regulations for LSEVs.

The large number of densely populated cities and rising per capita incomes is creating a demand for personal transportation that cannot be met in an environmentally sustainable way using vehicles powered by an internal combustion engine (ICE). With all of the growth in China's auto industry, there is still less than one car for every six individuals in the country, compared to the United States where there is nearly one car for every man, woman, and child. Under these circumstances, China simply has no choice. The country must either accommodate a growing number of ICE powered vehicles with all that implies as far as air pollution and energy dependence; restrict the transportation choices of its citizens; or embrace new technologies such as NEVs.

For this reason, China has heavily subsidized the purchase of NEVs, with subsidies from both the Central and local governments that can total as much as $10,000 per car, depending on range. In addition to subsidies, many cities provide favorable policies such as the assured issuance of a vehicle license and increased access to HOV lanes. As reported by *MTD* in October, China plans to eliminate individual subsidies by 2021 and shift the burden of promoting NEV sales to auto companies by requiring that a certain percentage of vehicles built and sold in China be comprised of NEVs beginning in 2019. Failure to comply with the new rules will result in restrictions on production and sales of a sufficient number of ICE vehicles to bring the car company in question into compliance.

Despite the shifting sands of EV rules and subsidies, NEV sales in China will increase by at least 30 percent to over 1.0 million units in 2018.