

Vanguard's 2018 economic and market outlook

Vanguard's outlook for China

Lara de la Iglesia: I have two questions on China, one from Simon in Pennsylvania, and one from Dan in Illinois. And Dan actually asks, "Does China have a credit problem?" Simon's a bit more broad. "Can you talk about the risks in China coming from overcapacity in the hot property market?" So just views on China a little bit more specifically.

Joe Davis: Well, they have a credit problem, so I'll be a true economist here, yes and no. But there's a reason why I do so. Why I say no is, China, they have such a high savings rate that that savings gets recycled, as it should, recycled into both investment, and with that, primarily through the banking sector, that's why credit is created. So they will have significant credit growth, particularly in the course of their financial development.

That said, we spent a great deal of time over the past several years, along with Qian [Wang], our chief economist for Asia, looking at the overcapacity in China, because that is what has concerned us the most. Because that has implications not only for China's development, the risk of hard landing, it's also, importantly, in terms of, are the global deflationary forces moderating? Because China's been a significant influence there, given the excess capacity of the state-owned enterprises. So they have made progress. We thought they would make some modest progress, particularly for steel, coal, and so forth. It hasn't been as aggressive as I personally would like, but it has been in the right direction and something President Xi has called out as part of the five-year plan.

So we're not bearish on China in the short term. We don't see a hard landing. We still view China in this fight-and-retreat mode, of intentional slowdown, but when growth comes in, which typically happens every six months below their general 6%-ish or so target, they will fight it and stimulate, and then inevitably growth spikes for a time. Then they will retreat from the battlefield, so to speak, but they are more intent on it, I think.

So the good news is, they're more intent on eradicating or addressing the overcapacity of state-owned enterprises. They're very inefficient, unproductive, and some [are] losing money. But state-owned enterprises as a share of China's economy has come down drastically. So they've made a great deal of progress, but they need to continue to make progress if two things are going to happen: China's going to open their capital account and freely float their currency, and if China's going to escape the middle-income trap. And the other good news is that obviously Chinese policymakers know very well everything I'm talking about and then some. It's been foolish to doubt Chinese policymakers' resolve in this regard. But they still need to make more progress.

Lara de la Iglesia: So Jason asks, "Specific to China, is there a possibility that the Chinese economy is evolving such that the old-line manufacturing sectors are declining, but the higher tech, less capital intensive growth sectors are stronger than realized?"

(continued on next page)

Meet the speakers



Lara de la Iglesia
Moderator



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Joe Davis: Yes, that's a great point. In fact, as part of our economics team, we've developed for some time, we have real-time measures of both what we would call their old economy and their new economy. Their new economy—if you think of [it] even more broadly as the service sector—the service sector now exceeds the manufacturing sector in China. So this notion that China is solely a factory with excess capacity is a mischaracterization and has been for some time, which is why I think we—it's more likely than not, clearly more likely than not—that we won't have a hard landing, in part because of the service sector, which is more productive, growing more quickly, and clearly has high rates of return on capital. So that's all good news.

Even recent travel to China, if any of the viewers have been to China, they have leapfrogged, I would clearly say, the West as well as the United States on certain adoption of certain technologies. So things such as mobile pay, they're years ahead of the United States. So they're making progress, lightning-quick progress, on a number of fronts. That said, they still have some challenges they have to work through. But it is important, and it's something we look at very closely when we take into account these risk factors for our market outlook.



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