GavekalDragonomics

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The Chinese Consumer: Outlook & Trends 2017

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Outline: cyclical outlook & structural trends

After a weaker-than-expected 2017, a better 2018

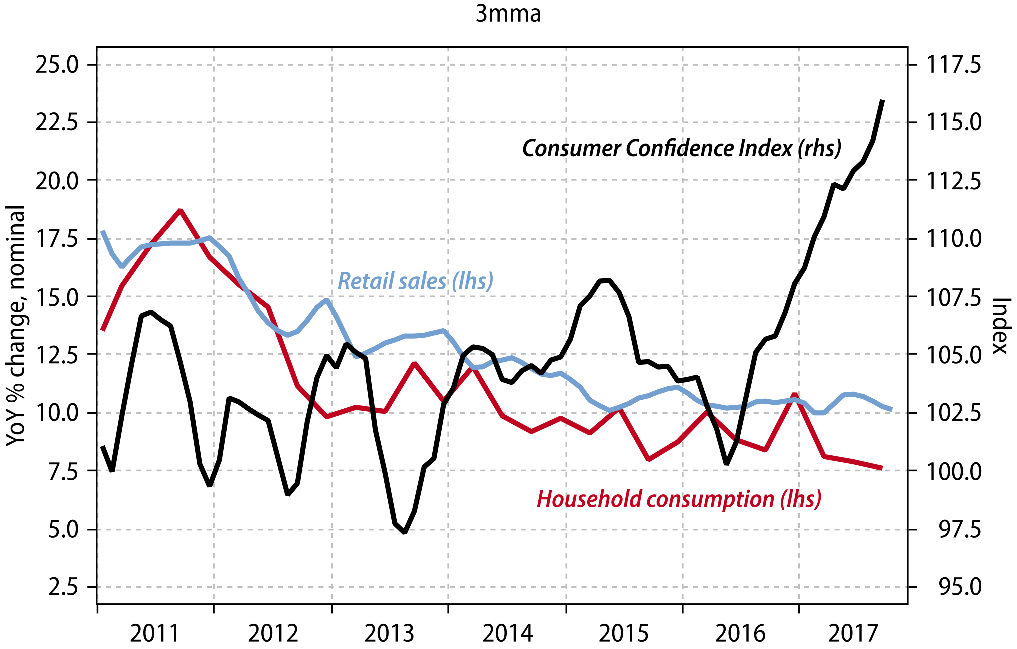
- The **labor market tightened** in 2017 and wage growth picked up, reflecting the cyclical recovery in the economy since 2016. Despite this improvement and some strong readings in high-frequency data, growth in **household consumption has been decelerating.**
- This divergence between income and consumption trends is unusual for China. The main explanation is that the unprecedented surge in mortgage borrowing has led to **higher household debt service costs**. Growth in income after mortgage payments has not picked up.
- Also weighing on consumption in 2017 were some **events affecting major consumption categories**: car sales are slowing after a tax break; there was a lull in the mobile phone upgrade cycle; and tourism to Thailand and South Korea took a hit.
- For 2018, leading indicators point to a solid job market and continued income growth. Debt service costs' **drag on consumption should lessen** as mortgage growth slows. Outbound tourism is also already on its way to recovering, and there is hope for a decent mobile phone upgrade cycle.

Trends favor upgrading and channel integration

- Beyond cyclical swings, there is a broad trend of so-called consumption upgrading, meaning that premium and **higher-end products tend to outperform.** We analyze this using the "acceleration phenomenon," which links the performance of particular markets to the number of households crossing affordability thresholds.
- Starting around 2010, **the number of households crossing the "affluent" threshold is accelerating**, while the number crossing lower income thresholds has plateaued. Therefore, products favored by affluent households are experiencing stronger demand growth.
- China's transition to online retailing has been very rapid, but **online retail has already passed its peak growth** point and is now maturing. The pressure on offline retailers also seems to have lessened.
- With the rapid spread of mobile payments, offline retailers are now more able to take advantage of online systems. In the future, **the distinction between online and offline retail will blur**, as online retailers are now focusing on a strategy of integrating with offline channels.

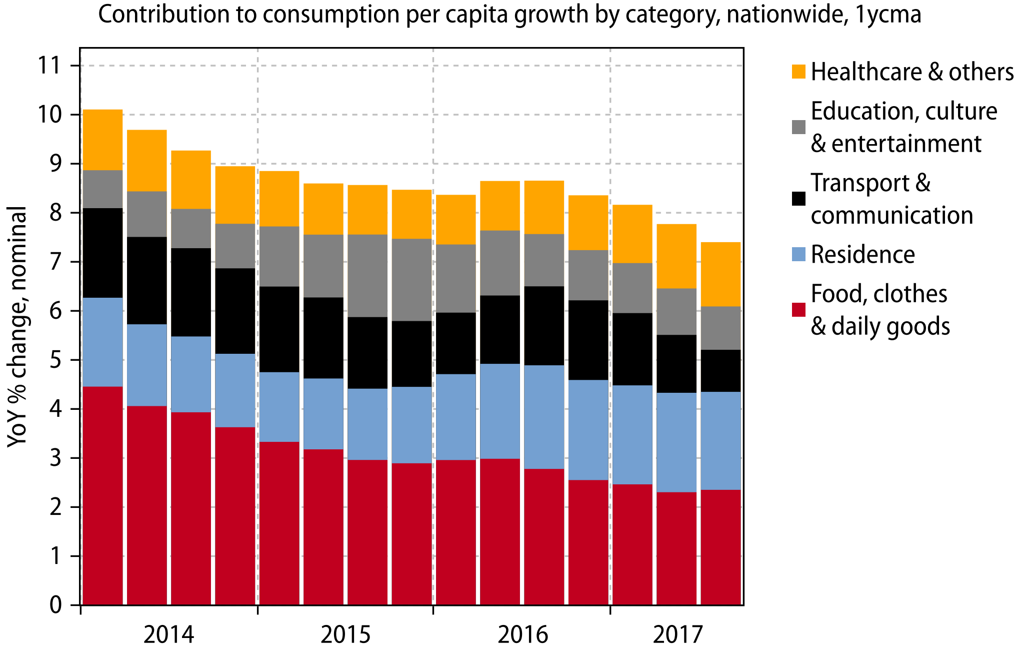
Consumption growth softened in 2017

Although data has been noisy, true consumption spending is weakening



CEIC, Gavekal Data/Macrobond

Consumers are mostly cutting back spending on services



CEIC, Gavekal Data/Macrobond

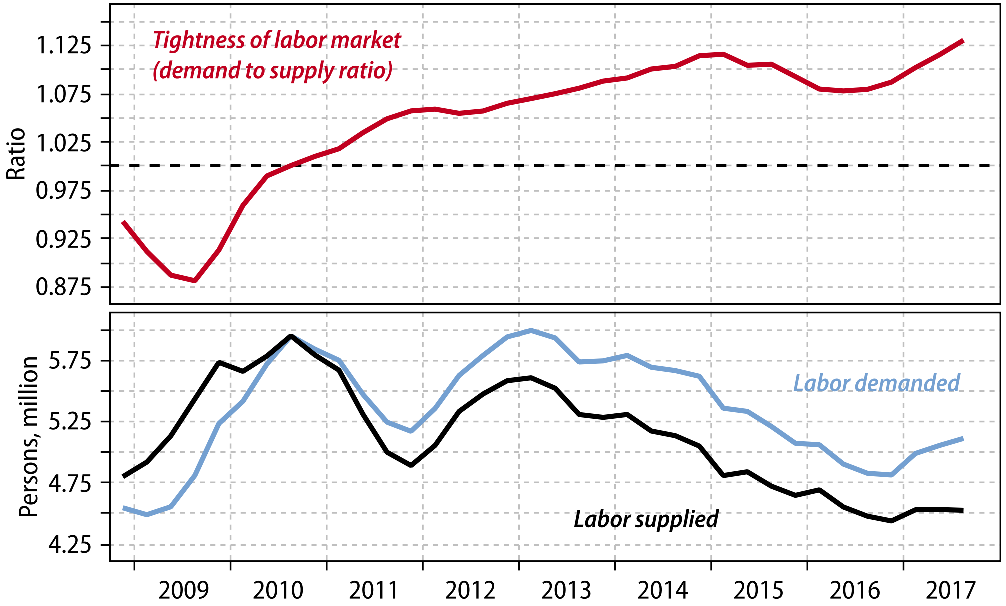
High-frequency consumption indicators are showing diverging trends in the first three quarters of 2017: consumption in the household survey has been decelerating, while retail sales has been stable or improving and the consumer confidence index has surged to new highs. How to interpret these conflicting signals? The confidence index can likely be ignored, as historically it has had little relationship to actual spending patterns.

Although it is less timely, I prefer the quarterly household survey to the other indicators, as it includes spending on services that are not covered by the retail sales figures, and also excludes the sales to non-households (companies & government bodies) that are included in retail sales. Most of the slowdown is in fact in services: transport, communication, education, and entertainment dragged down consumption growth by 1.7pp this year, two-thirds of the slowdown.

Weakness in consumption cannot be blamed on the labor market

Labor market is improving, supporting wage growth

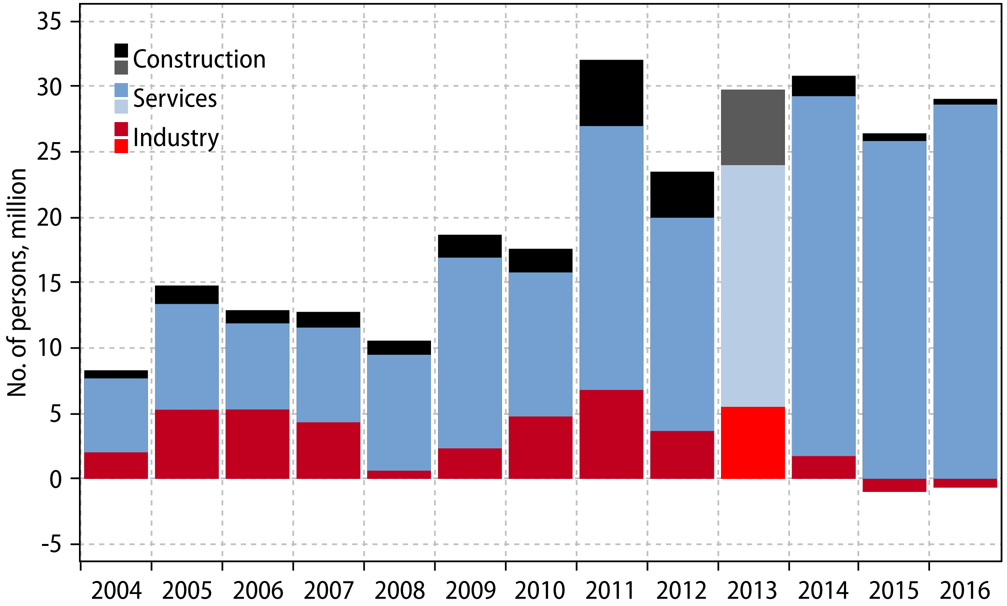
Labor demand and supply, from urban job placement centers, 1yma



Gavekal Data/Macrobond

Almost all new job creation is happening in services

Total non-farm employment by sector, change over previous year, 2013 adjusted



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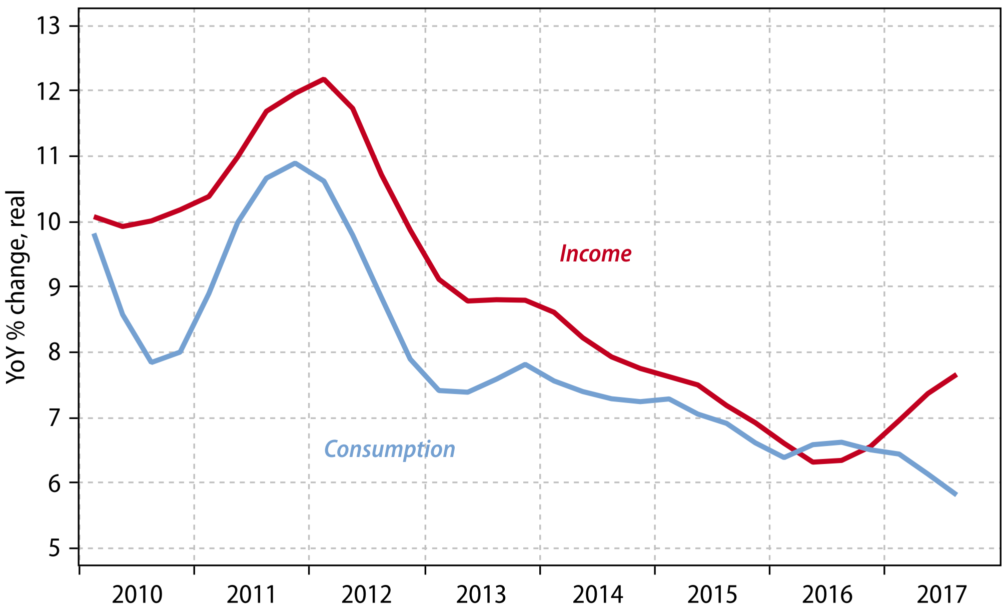
The labor market has tightened in 2017 as a result of the economic recovery since 2016, with the number of job openings outpacing the number of applicants. Large industrial layoffs weighed on the job market in 2016, and while layoffs in some troubled sectors are continuing this year, the pace is much slower. The usual pattern is for changes in the job market to lag growth by about a year, and this pattern has held up in 2017. The cyclical recovery has indeed translated into a tighter job market and higher wage growth.

The millions of jobs being created in the service sector can easily absorb the loss of industrial jobs, but these new jobs may not be equivalent to the ones being lost. Most new service jobs are in small businesses or self-employment, and therefore offer lower wages and less security. The labor market is thus undergoing structural change to less stable and secure employment. This fact will not stop the cyclical trend of wages improving, but it does suggest there may be less upside for wages in this cycle.

Higher mortgage payments leave less money for other spending

Income is recovering while consumption is weakening

Household income & consumption per capita, nationwide, 1ycma



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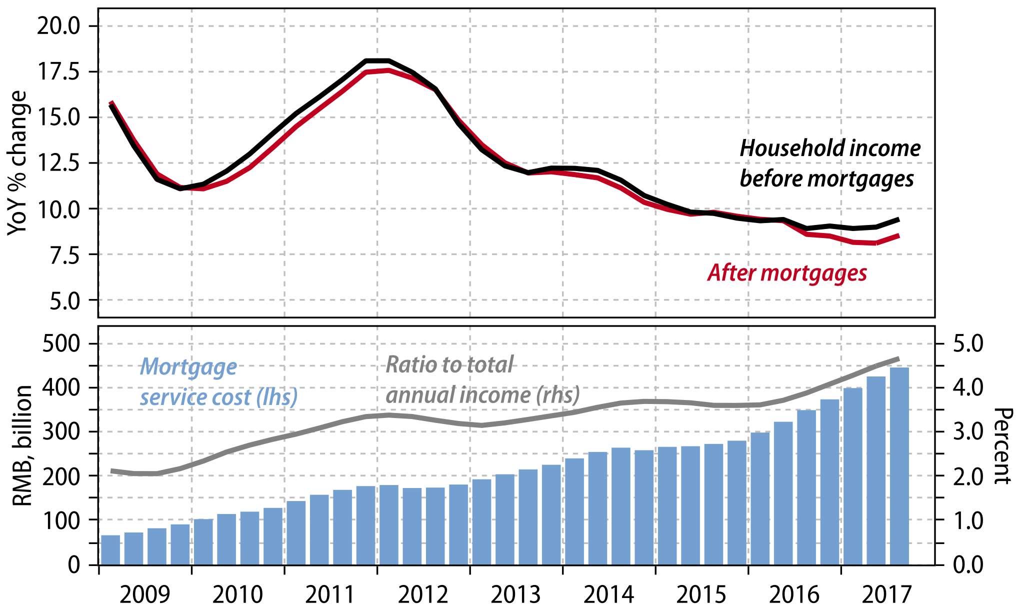
Rising mortgage debt is cutting into household budgets

National aggregates; assumes 20-year average mortgage with fixed payments



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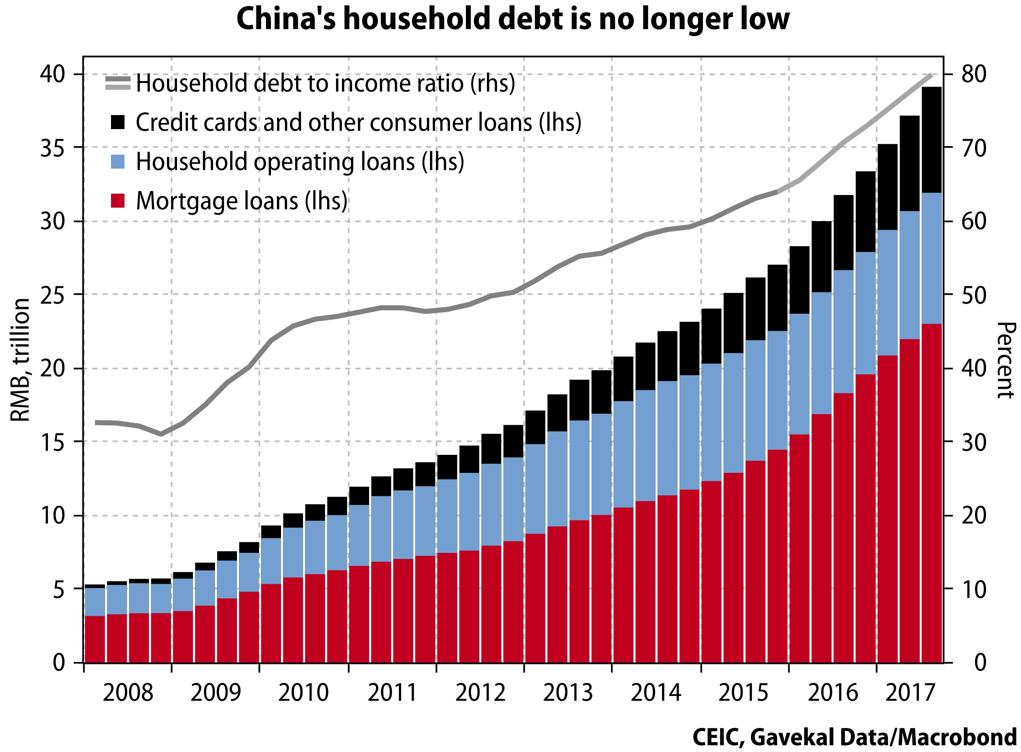
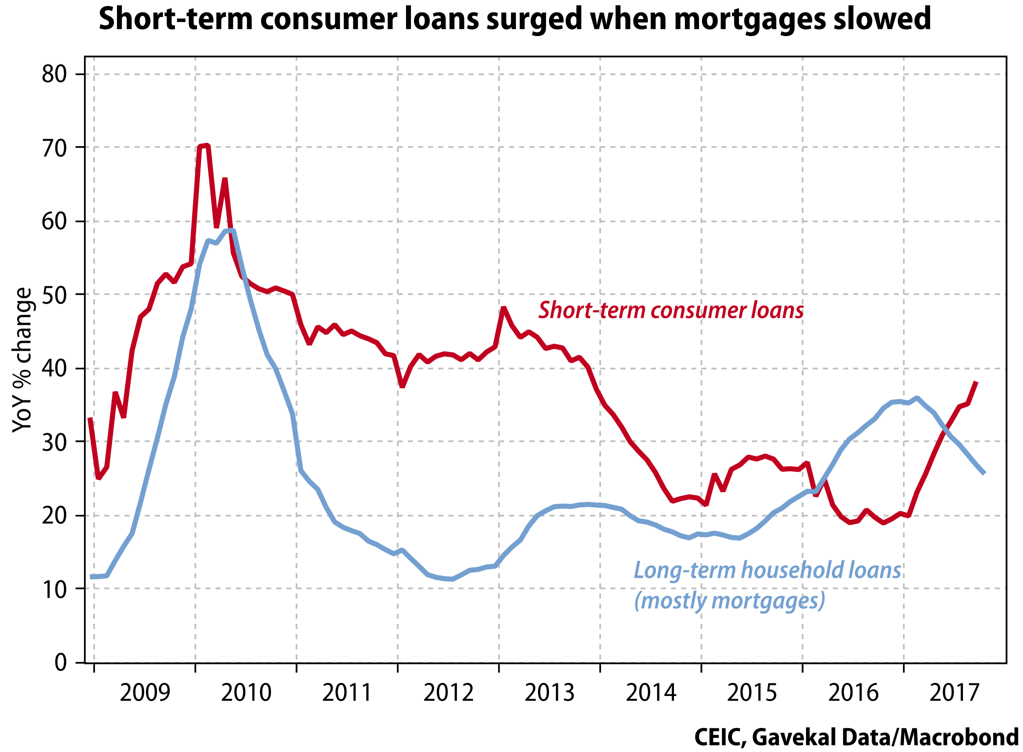
The improving labor market has led to a pickup in household income, with real per-capita income accelerating to 7.5% YoY growth in the first three quarters of 2017, from 6.3% in 2016. Real per-capita consumption, however, has slowed to 5.9% YoY real growth in the first three quarters of 2017, from 6.8% in 2016. Such a divergence between income and consumption growth is highly unusual in China. While there are some temporary factors weighing on spending on some major consumer items, rising debt also plays a role.

The huge surge in mortgage borrowing in the recent housing cycle has shrunk how much income is available for other spending. Growth in outstanding mortgage loans went from 17% in early 2015 to a peak of 35% at end-2016, and slowed down very gradually to 26% by 3Q17. Mortgage servicing costs have gone up to 4.7% of total annual household income, from 3.6% in 2015. This has dragged down growth in income after mortgages by nearly a full percentage point, eating up almost all of this year’s improvement in income growth.

Household debt has risen substantially





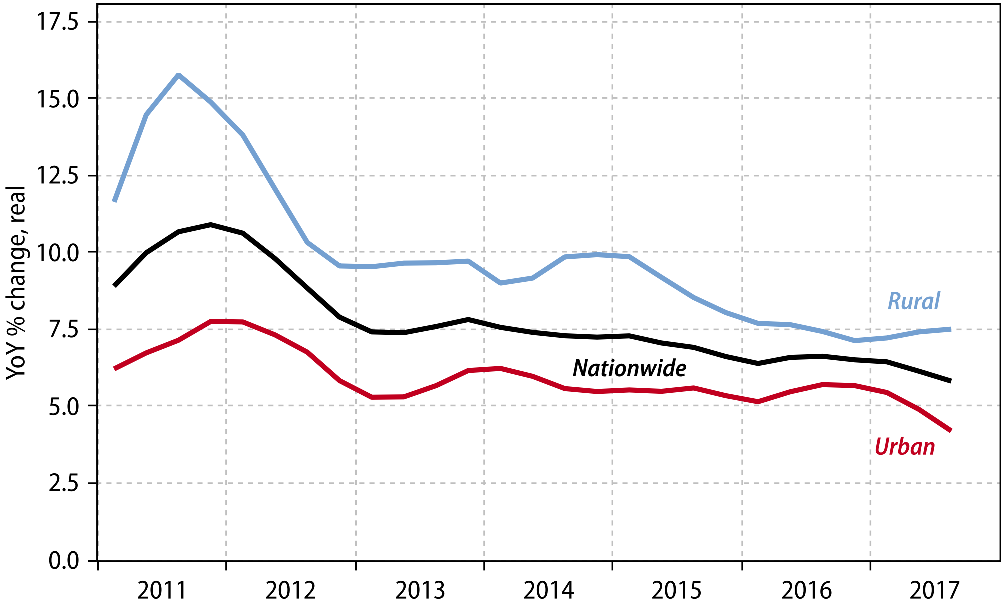
The dramatic expansion in household leverage is a major economic shift over the last couple of years. The surge in mortgage loans that began in late 2015 is the major contributor, though other forms of household debt have also risen. The household debt-to-GDP ratio is now approaching 50%, from 40% in 2015. I estimate household debt reached 80% of household income in the first three quarters of 2017, a sharp jump from 64% in 2015. This ratio is on pace to approach the US level, currently around 100%.

Access to mortgages began to get tighter in early 2017, as many cities implemented restrictive housing policies. As this happened, there was a sharp acceleration of short-term consumer loans, from around 20% YoY in late 2016 to nearly 40% YoY in Sep. In the past such debt, much of which is on credit cards, was correlated with consumer spending, but not this time. At least some of these loans are likely disguised mortgages; regulators have punished several Chinese banks for misusing consumer loans for housing.

Rural consumption has done well even as urbanites cut back

Consumer weakness is mostly urban, with rural spending picking up

Household consumption per capita, by urban and rural, 1ycma



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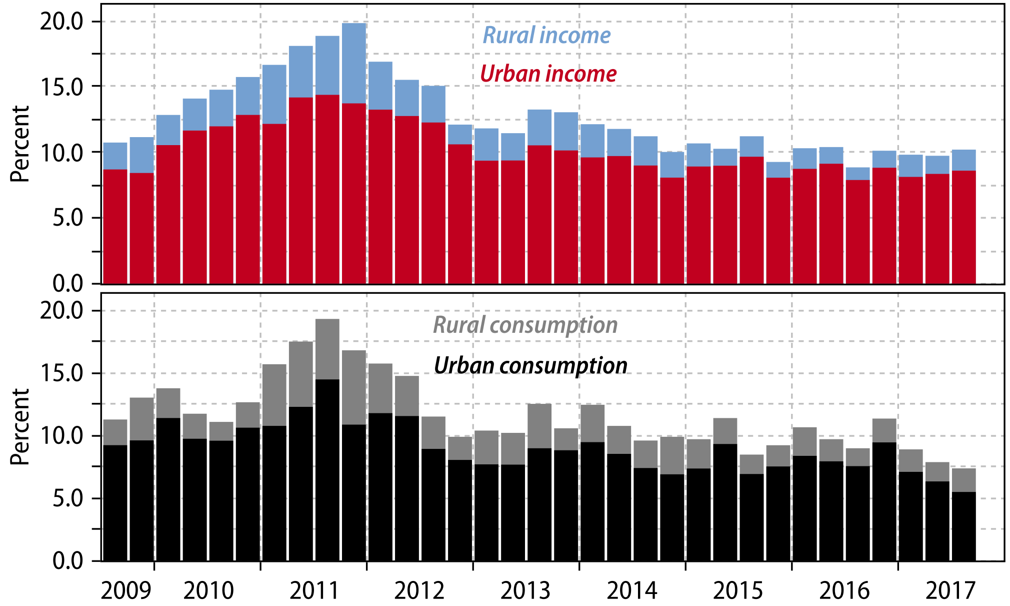
Urban consumption slows down, while income holds up

Contribution to income and consumption nominal growth by urban and rural



CEIC, Gavekal Data/Macrobond

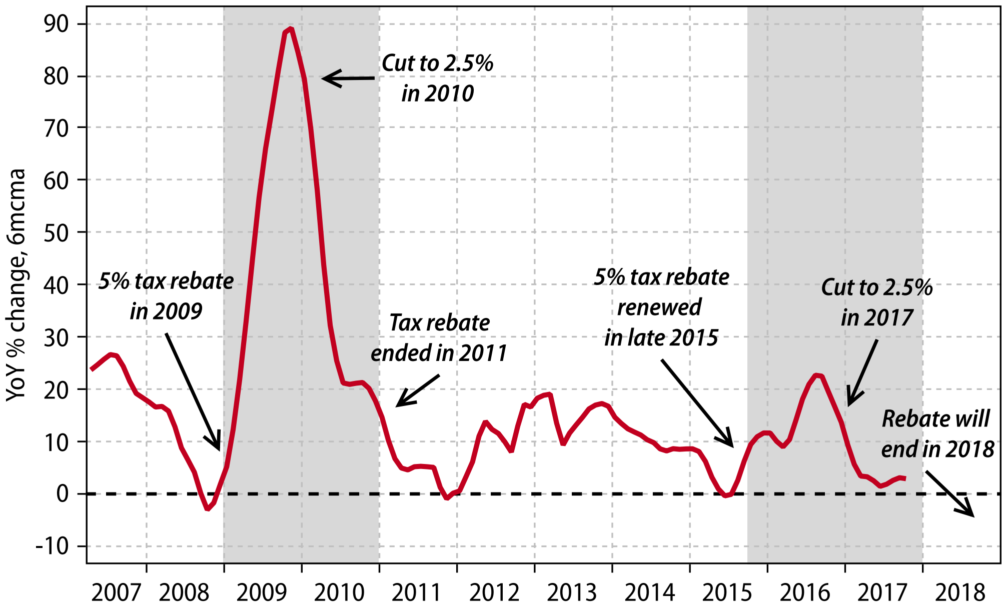
Looking at the urban-rural breakdown in the household survey, rural consumption has picked up this year, as would be expected from the strengthening job market. Rural consumption has been strengthening from 6.8% YoY real growth in Q1 to 8.3% YoY in Q3, while urban real consumption growth slowed down from 5.4% YoY in Q1 to 3.3% YoY in Q3. However, rural consumption is small, 40% of the urban level on a per-capita basis, and accounts for only a quarter of total nationwide consumption spending.

The slowdown of nationwide consumption growth is therefore mainly coming from urban consumers. Since mortgage debt is essentially an urban phenomenon, this supports the argument that higher debt service payments are crimping consumption. There have also been downturns in autos, mobile phones, and tourism in 2017, mostly for idiosyncratic rather than macro reasons. Urban consumers are also mainly responsible for these types of spending. The following slides cover these areas in more detail.

Car sales slowed in 2017, and will likely further weaken in 2018

Car sales in 2018 is likely to remain weak with retreating tax rebate

Sales of passenger cars; shaded periods = tax rebates in effect



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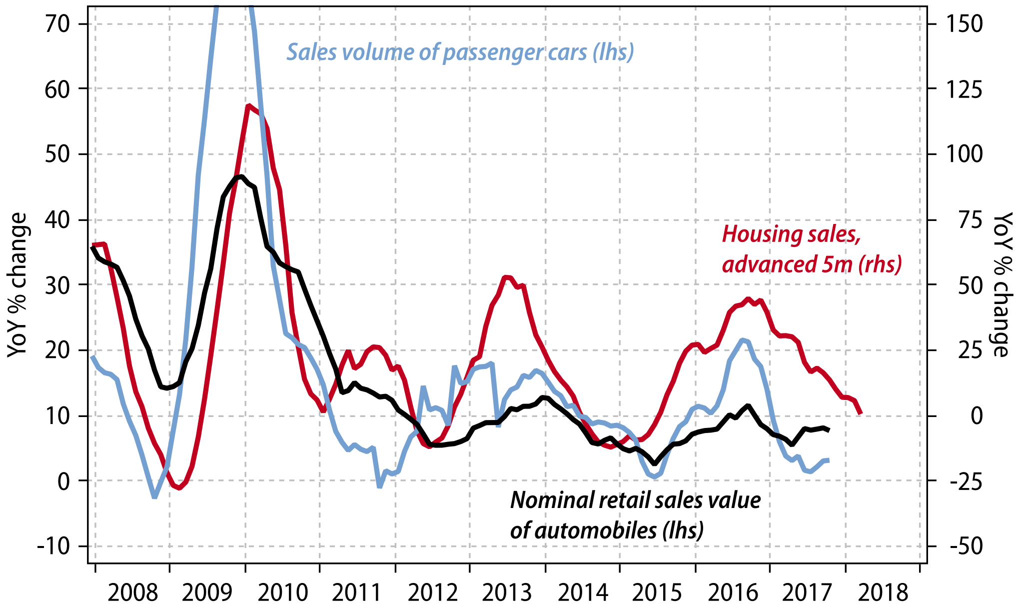
The slowdown of housing sales also points to weaker auto sales

7mcma



CEIC, Gavekal Data/Macrobond

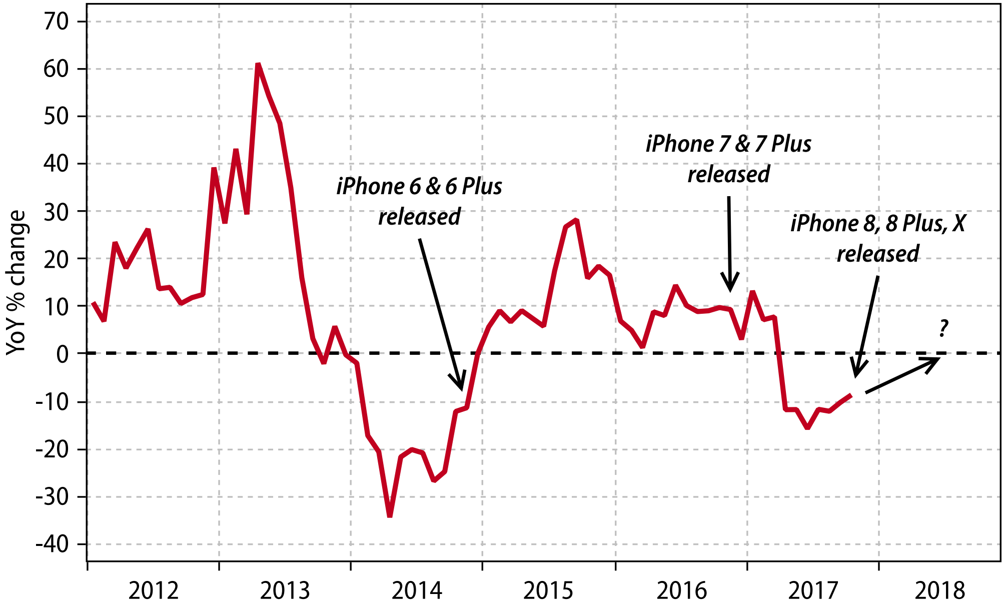
Car sales slowed down sharply in 2017, with growth falling below 5% in the first three quarters of the year. The government had stimulated car sales with a 5% tax rebate announced in late 2015, but this rebate was cut to 2.5% in 2017; many consumers therefore front-loaded purchases into 2016, resulting in weaker sales this year. The tax rebate will end entirely in 2018. Based on the previous tax-rebate cycle over 2009-11, this will likely mean a further slowdown or even decline in car sales.

Another signal for a further slowing car market is its correlation with housing sales. Car sales and housing sales have long been tightly correlated, as new households often purchase a car and a home at roughly the same time. The slowdown of the property market since late 2016 thus points to a further slowdown of car sales in 2018. However, car sales are also now increasingly driven by replacement demand instead of first-time purchases, so the impact from slowing housing sales may be less intense in this cycle.

The mobile phone upgrade cycle may return in 2018

Mobile phone sales could recover next year with a new upgrade cycle

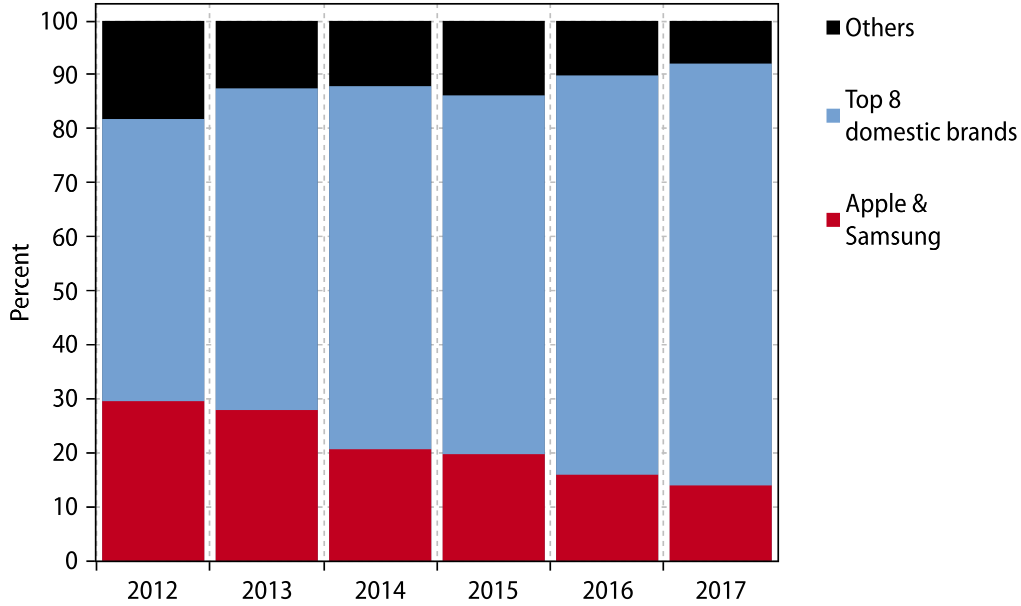
Mobile phone unit shipments, 3mcma



Wind, Gavekal Data/Macrobond

Apple & Samsung are losing market share to Chinese competitors

Market share of smartphones, by retail sales volume



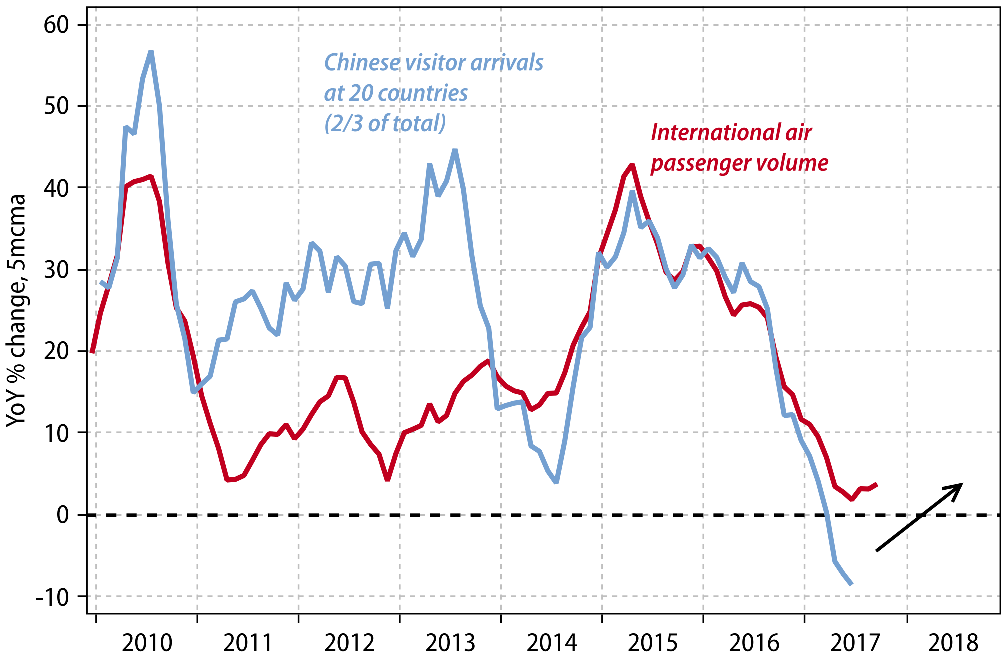
Euromonitor, Gavekal Data/Macrobond

Mobile phone sales have been shrinking since Q2, likely a result of a lull in the upgrade cycle. With very high penetration of smartphones in China now, sales will be mainly driven by upgrading and replacement rather than market expansion. Upgrading usually follows a 2-3 year cycle, and the latest iPhone model seems to be better received than the previous one; the last big upgrade cycle happened after the release of the larger-screen iPhones and switch to 4G in 2014-15.

The release of new iPhone models may have less influence on overall Chinese market volumes than in the past, as Apple's market share has shrunk amid an explosion of low-cost domestic phone offerings. The market share of Apple and Samsung together, has shrunk to only 14% in 2017, half the level in 2012. Domestic smartphone makers, meanwhile, now account for 80% of shipments, with a particular advantage in smaller cities and lower-income areas.

The 2017 decline in outbound tourism should be temporary

Outbound tourism plunged in 2017, but should recover in 2018



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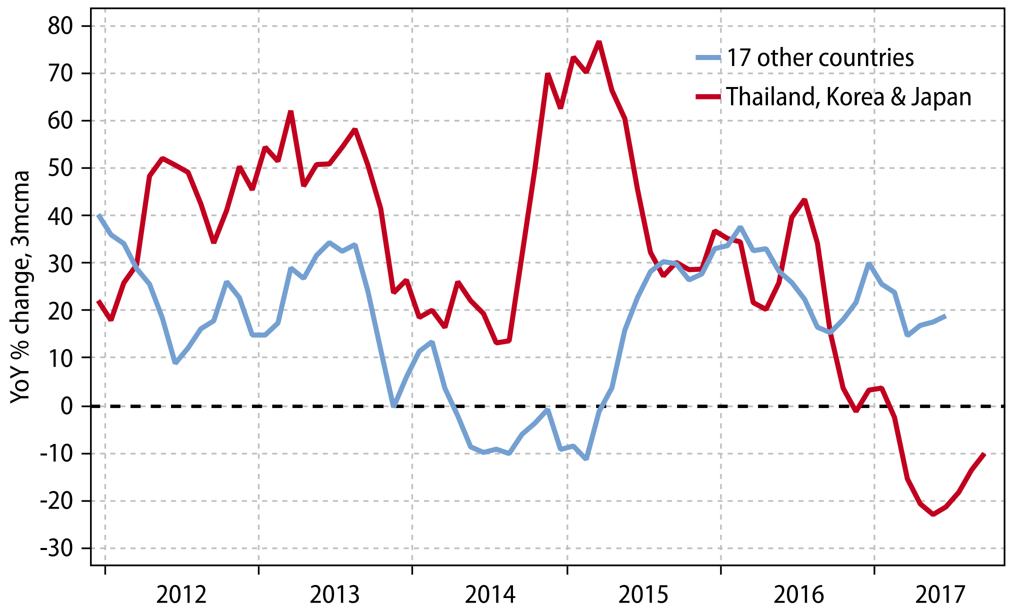
The drop in outbound tourism is mainly due to the top 3 destinations

Chinese visitor arrivals, by country group



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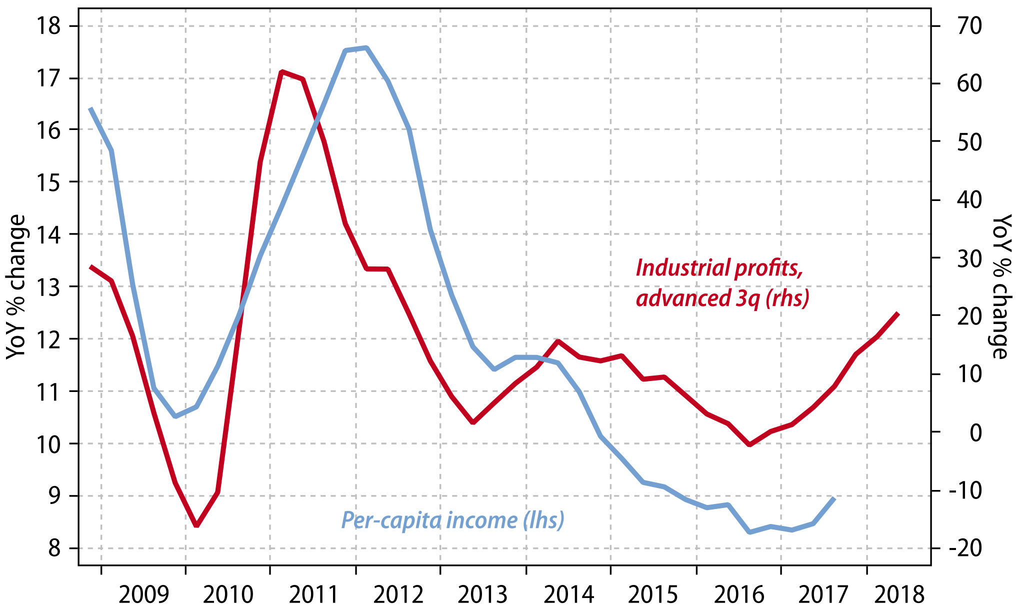
Chinese outbound tourism has suffered a dramatic slowdown since late 2016, as indicated by both visitor arrivals from 20 countries with frequent data release (2/3 of total), and China's international air passenger traffic. This slowdown is likely to be a blip, caused by disruptions in major tourist destinations, and China's outbound tourism growth should recover in 2018 as the effect of those events fades. Spending by Chinese outbound travelers reached US$261bn in 2016, and is on pace to rise more slowly to around US$270bn in 2017.

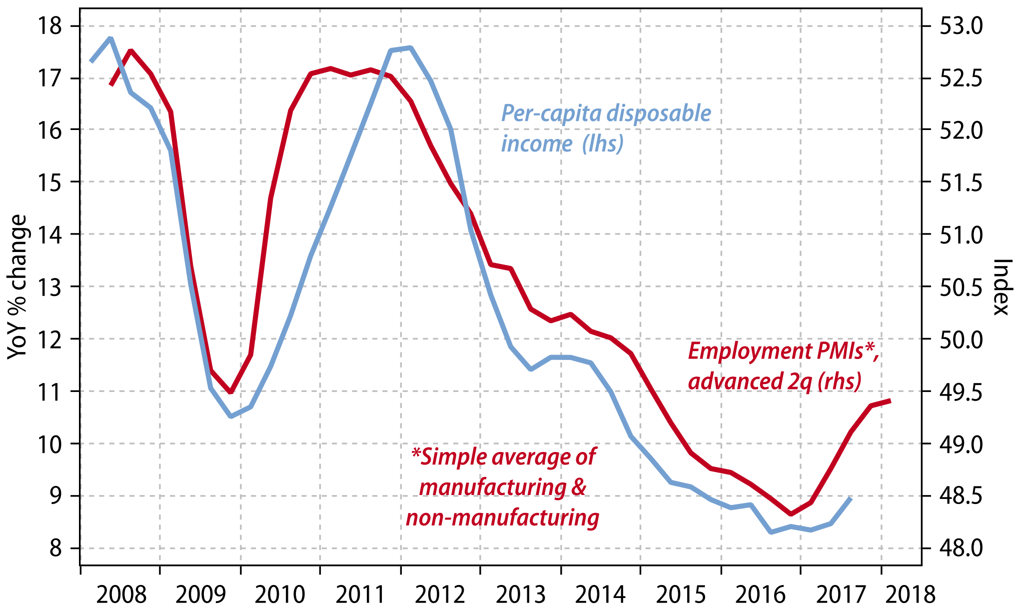
Chinese outbound travel is highly concentrated in a few countries, with the top three destinations (Thailand, South Korea & Japan) accounting for 40% of visitors. The decline in visitors is mainly due to the national mourning period in Thailand after the death of its king, and China's ban on tour groups to Korea in retaliation for a diplomatic slight. Travel to both destinations has already bottomed out, and should return to positive growth in 2018. I believe outbound tourism still has more years of rapid growth ahead.

Outlook for household income in 2018 is solid

The profit cycle points to an upturn in household income...



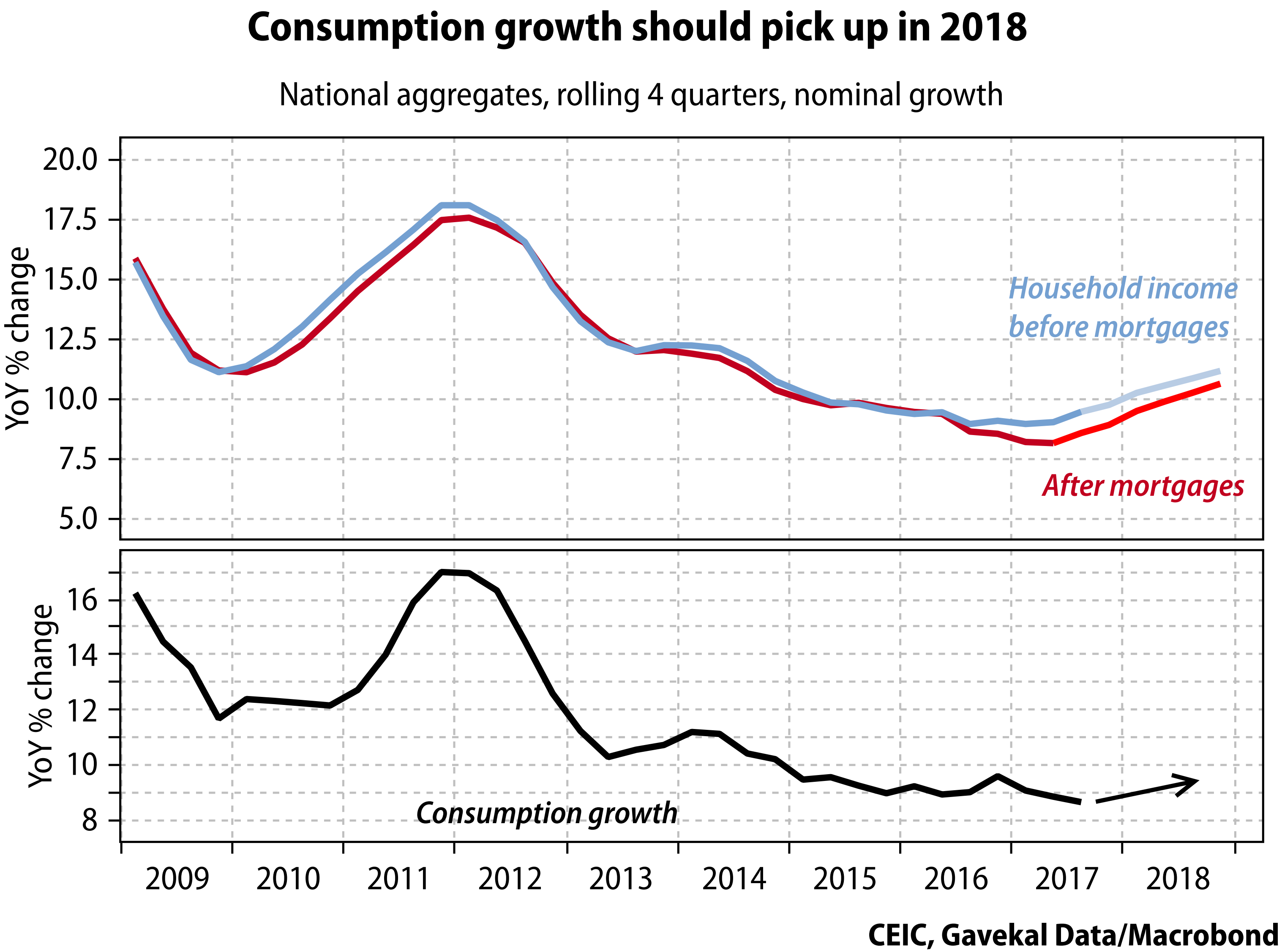
...as do employer surveys



Looking forward to 2018, household income growth is likely to strengthen further, due to the lagged impact of the continued recovery in economic growth and corporate profits in 2017. The profit cycle is usually a good leading indicator for employers' demand for labor, so the strong profit growth in 2017 should mean an even tighter labor market and stronger wage growth in 2018. However, the latest recovery in industrial profits is driven by metals and commodity prices, and so may not boost overall incomes as much as in the past.

The employment components of the monthly PMI surveys are another a decent leading indicator for household income. And as employment PMIs are available for both the manufacturing and services sectors, they may provide a broader picture than industrial profits. The usual lag between the PMI and household income points to continued improvement through end-2017, though the momentum of income growth could soften in early 2018. Overall, leading indicators point to a decent job market next year.

Mortgages should be less of a drag on consumption in 2018



The gap between income and consumption growth widened in 2017 due to rising mortgage service costs, but this gap should narrow some in 2018 as growth in mortgages slows.

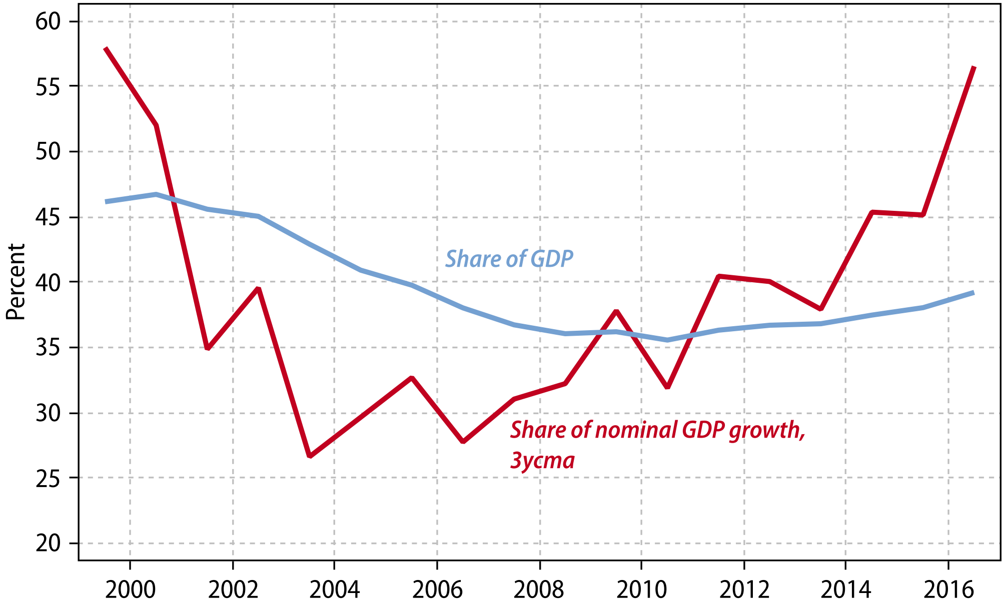
My projection for mortgage service costs is based on a further slowdown in mortgage growth to 20% by end-2018. This suggests debt service will cut income growth by about 0.5pp by end-2018, compared to 0.9pp in mid-2017.

The relationship between income and consumption growth should thus be tighter next year, with more income growth translating into consumption. Some one-off factors dragging on specific types of spending should also vanish in 2018.

The share of household income and consumption in GDP will keep rising

China's consumption has been increasingly important in GDP growth

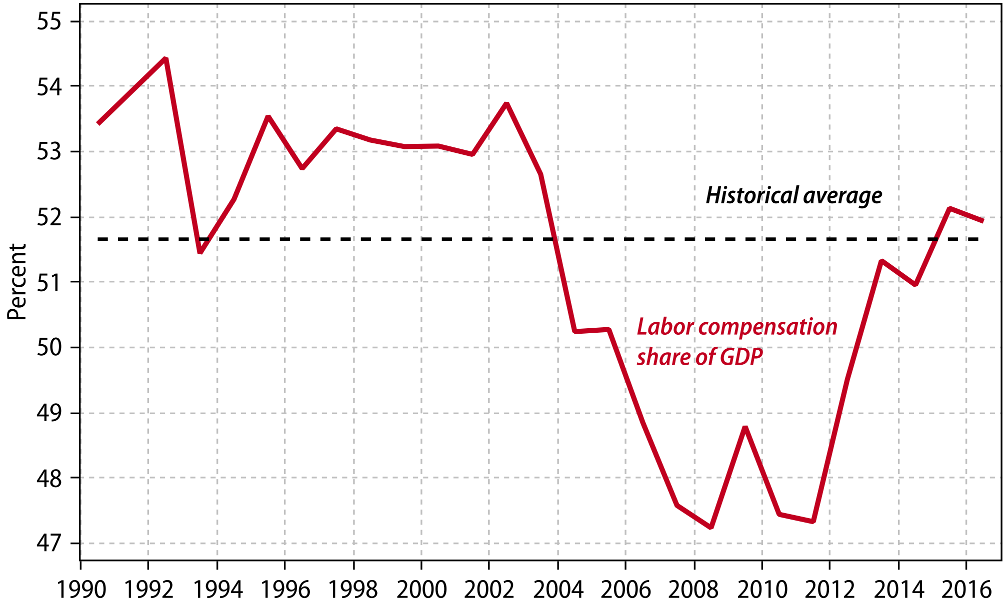
Household final consumption expenditure's share of GDP and GDP growth



CEIC, Gavekal Data/Macrobond

Labor's share of GDP has also been increasing in recent years

From flow of funds; 2016 estimated based on provincial data



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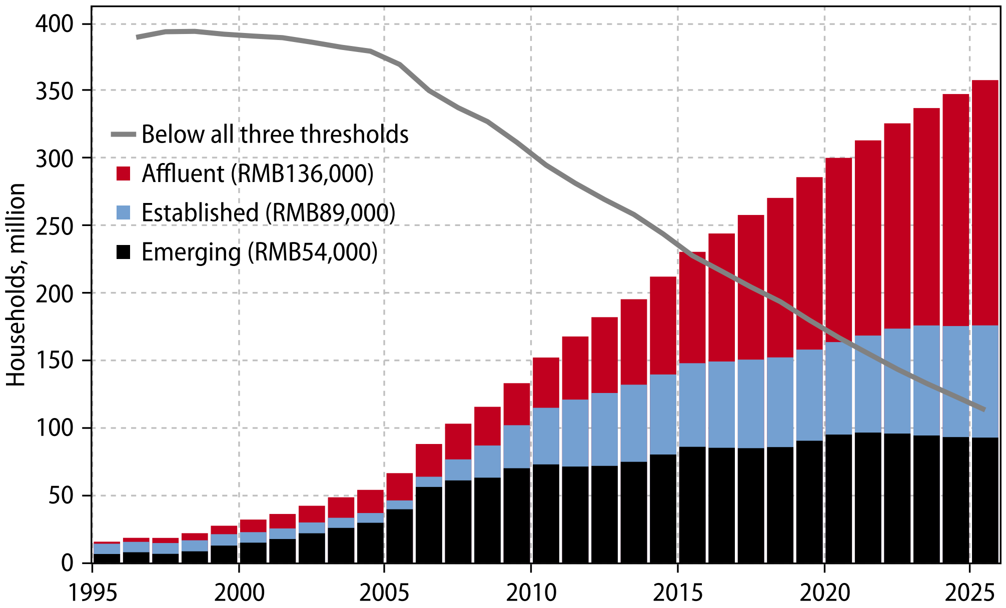
With solid growth in household income and consumption, the share of household consumption in GDP should continue to rise from the 39% in 2016. This rising trend since 2011 is mainly due to the substantial slowdown in investment growth, to just over 6% in real national-accounts terms since 2014, from 15%-plus in 2007-10. Consumption growth has slowed too, but not as much. Investment growth will likely slow down further in 2018, allowing the consumption share of GDP to rise moderately again.

The share of labor compensation in China's national income has also been increasing in recent years and is now around 52%, up from a low of 47%-48% around 2007-10. The decline in the labor share of GDP, as with the consumption share of GDP, was due to the big housing and investment boom, and its end means the labor share can rise. The labor share of GDP was over 53% in earlier decades, and a return to those levels or even higher seems quite plausible given that the labor-intensive service sector is now so much larger.

Consumption upgrading trend is driven by the acceleration phenomenon

Affluent households are now the fastest-growing consumer group

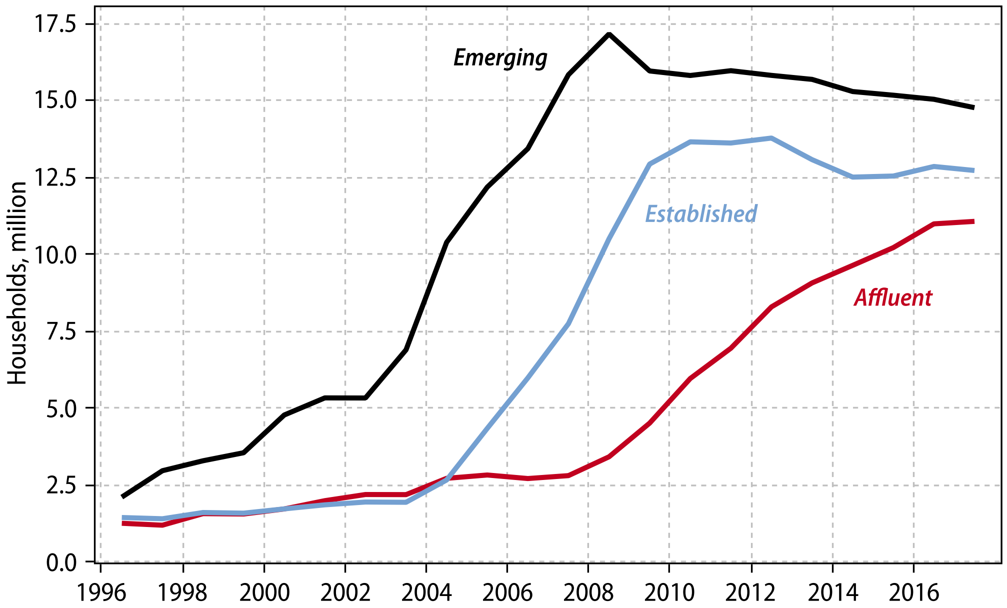
Number of households in each income group; projections for medium growth scenario



Gavekal Data/Macrobond

The three waves of the acceleration phenomenon

Number of households crossing each income threshold, 5ycma



Gavekal Data/Macrobond

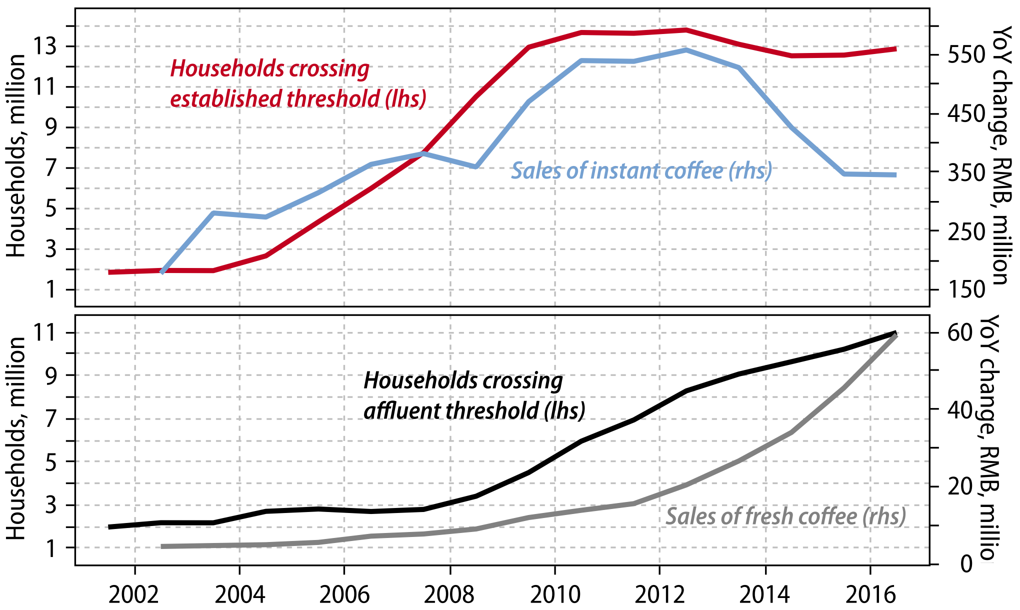
To understand structural changes in the patterns of consumer spending, we use a model of the "acceleration phenomenon." This is based on the fact that spending on particular goods and services can accelerate sharply when lots of households cross the appropriate threshold of affordability. We use three income thresholds: "emerging" consumers who buy basic mass-market products; "established" consumers who start buying branded consumer goods; and "affluent" consumers who are branching out into higher-end goods and services.

We estimate there were roughly 85mn emerging households, 66mn established households and 107mn affluent households by end-2017. But the key to the acceleration phenomenon is not knowing the absolute number of households, but pinpointing when growth in each group is fastest. Emerging and established consumers have already passed their growth peak, while affluent consumers are now the fastest growing consumer group. Therefore, premium and higher-end products are generally outperforming.

How the acceleration phenomenon plays out in different markets

Affluent households favor fresh coffee over instant

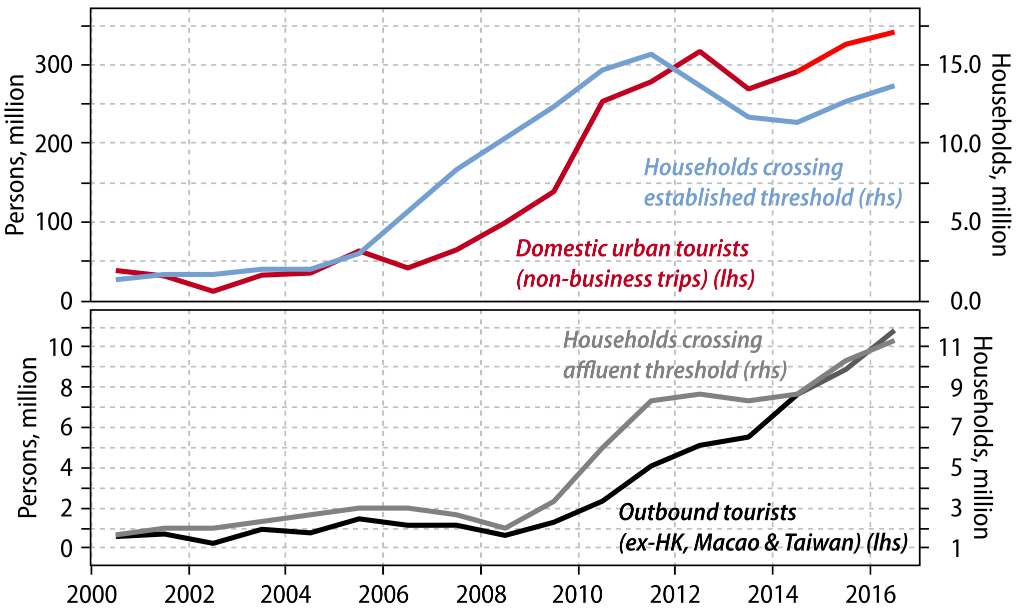
5ycma



Euromonitor, Gavekal Data/Macrobond

Affluent households are driving the boom in foreign travel

Annual increase of tourist visits & households crossing thresholds, 3ycma



UNWTO, Wind, Gavekal Data/Macrobond

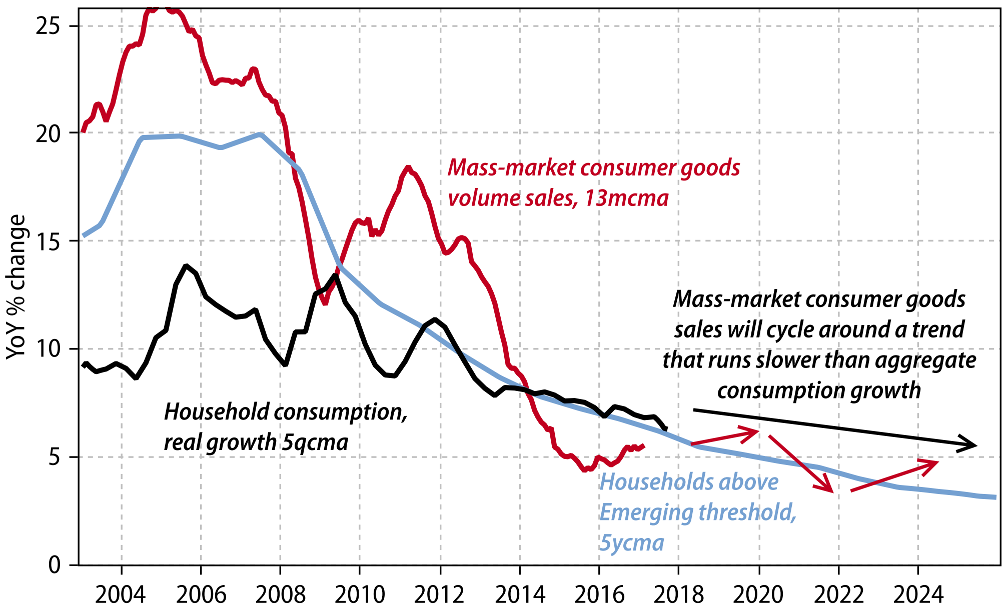
The acceleration phenomenon does not say anything about how fast China's total consumer spending will grow, but it is very useful for understanding which type of consumption is going to over- or under-perform. With the acceleration phenomenon shifting from established to affluent households, in most markets this means the high end will outperform the low end. For instance, since 2010 consumption of instant coffee has slowed down, while sales of more-expensive fresh coffee have begun to surge.

A similar dynamic is playing out in tourism, one of the biggest consumer services. The established consumer group usually favors cheaper domestic tourism, while more expensive outbound tourism is favored by affluent households. Domestic tourism had its strongest growth from 2005-10, when established households were the fastest-growing group. Outbound tourism has begun to surge since 2010, and with the number of affluent consumers rising rapidly, should still have a few more years of rapid growth.

The slowdown in mass consumer goods will be less sharp in future

The slowdown in many consumer goods will be more gradual from here

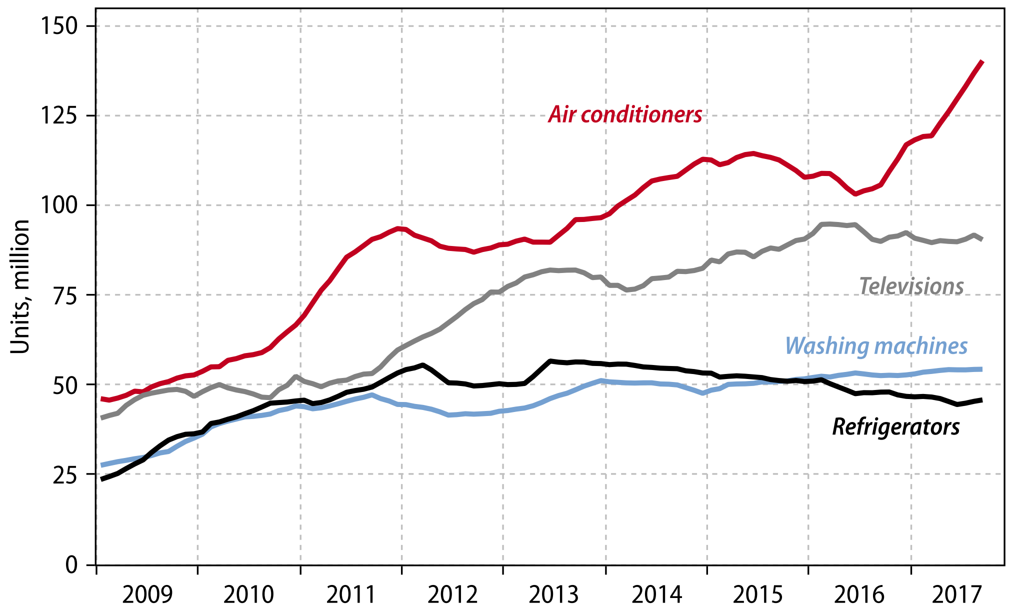
Sales of food, beverages, & clothing



CEIC, Gavekal Data/Macrobond

Appliance sales have peaked, except for air conditioners

Domestic sales volume of major appliances, annual rate



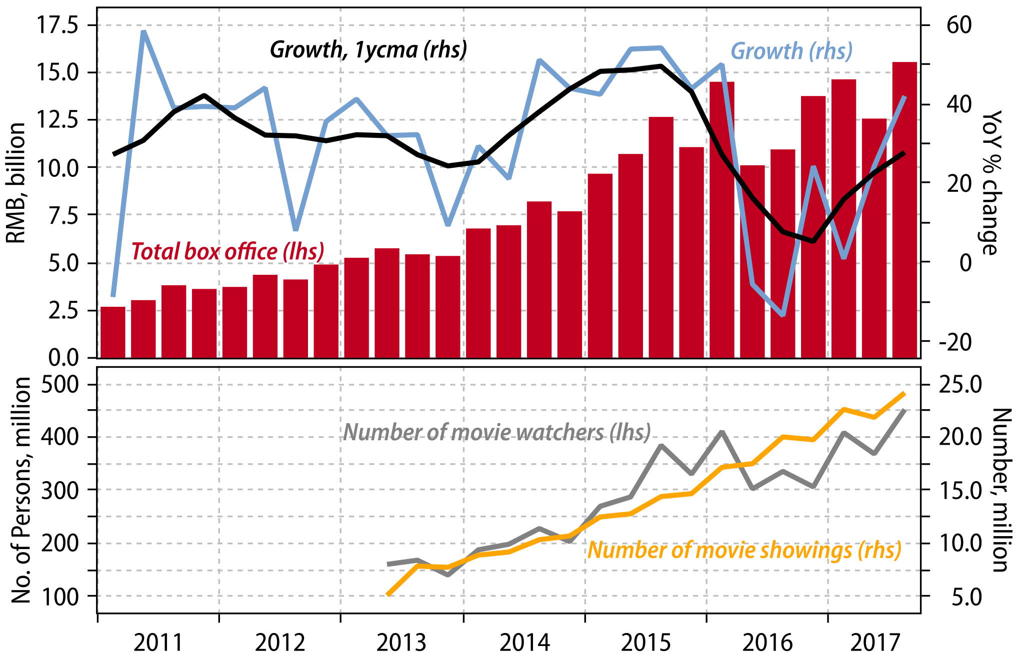
Wind, Gavekal Data/Macrobond

Mass-market consumer goods (food, beverages, and clothing) have gone through a rough few years as growth in their main market slowed and the number of affluent households surged. But the acceleration phenomenon model shows that the deceleration in the growth of emerging & established households will be much less dramatic in coming years. So while the numbers still look ugly in mass-market goods, from soft drinks to instant noodles, the worst should soon be over.

Home appliances have also seen a plateau or decline in sales in recent years, but the slowdown has become less dramatic and the deceleration of mass consumers is moderating. An exception to the stagnant appliance trend is air-conditioners, which can benefit from the rising size of housing units. Sales of air-conditioners are now growing nicely, and should still have a few good years left as households fit out larger apartments with more units.

Affluent households are not boosting every high-end market

Box office is volatile but seems to have passed its peak



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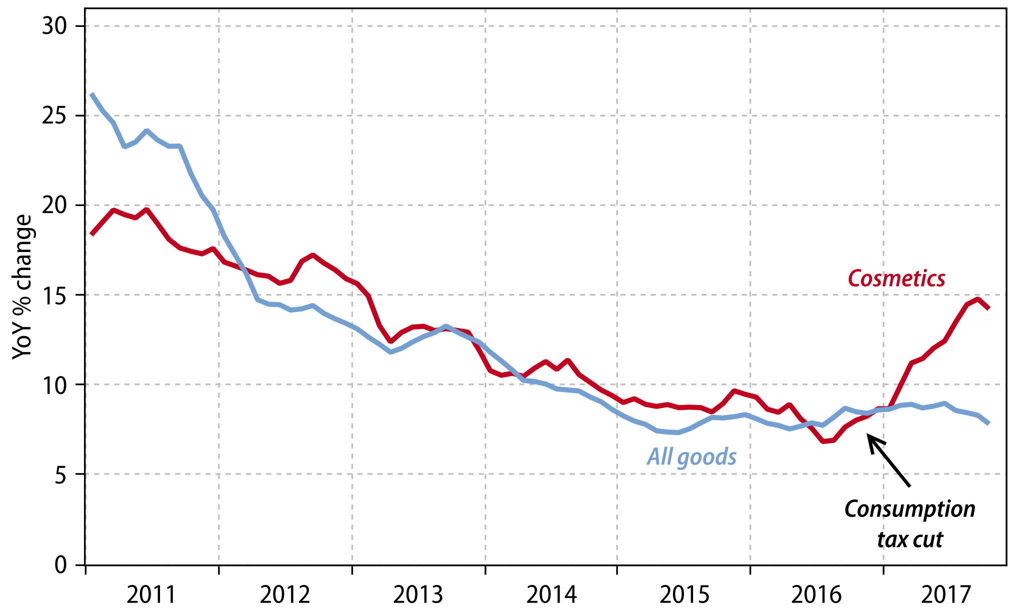
A tax cut gave a boost to cosmetics sales

Sales of above designated size retailers, nominal growth, 7mcma



CEIC, Gavekal Data/Macrobond

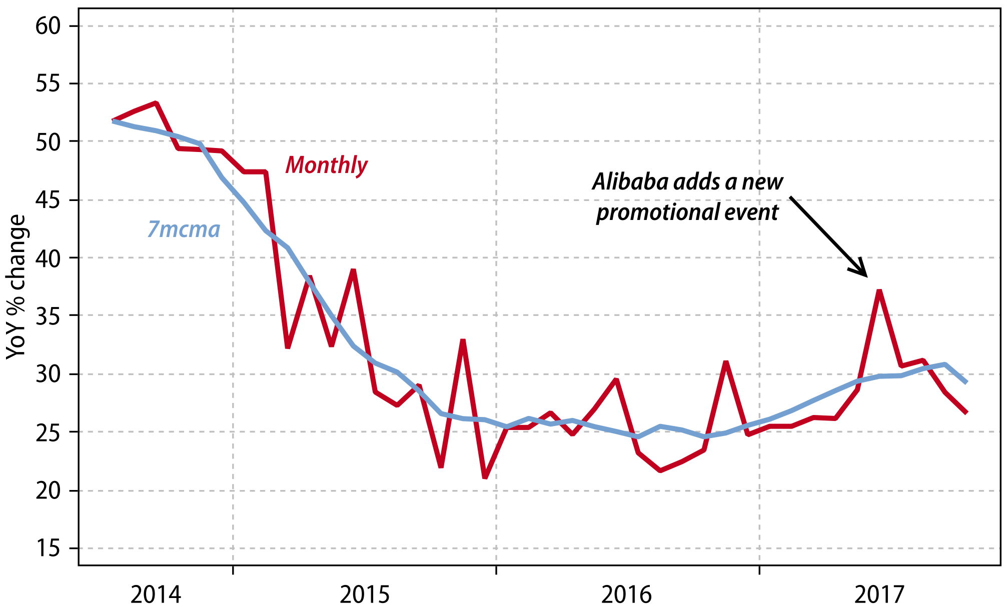
With affluent consumers willing to spend more on entertainment, box office revenues sustained booming growth of around 40% over 2011-15. But this boom has arguably led to overinvestment in movies and theaters, with supply outpacing demand. Movie viewing also fell off since mid-2016 due to a lack of popular films, though this decline reversed in Q3 after the local smash "Wolf Warrior II" brought in more crowds. While the movie industry is inherently volatile, it may have already passed its peak growth rate.

Cosmetics is another outstanding consumer sector in 2017, with sales growth accelerating to 12.5% YoY in the first ten months of 2017, from 8.3% in 2016. While cosmetics are usually considered a luxury good, this surge likely has little to do with the structural trend of rising numbers of affluent households. The surge in cosmetics sales started in October 2016 when the government cut the consumption tax on cosmetics. As the boost from this tax cut fades, momentum is likely to soften in 2018.

The transition to online retail is continuing, but at a slower pace

The recent bounce in online retail growth is a blip

Value of online retail sales, NBS estimate



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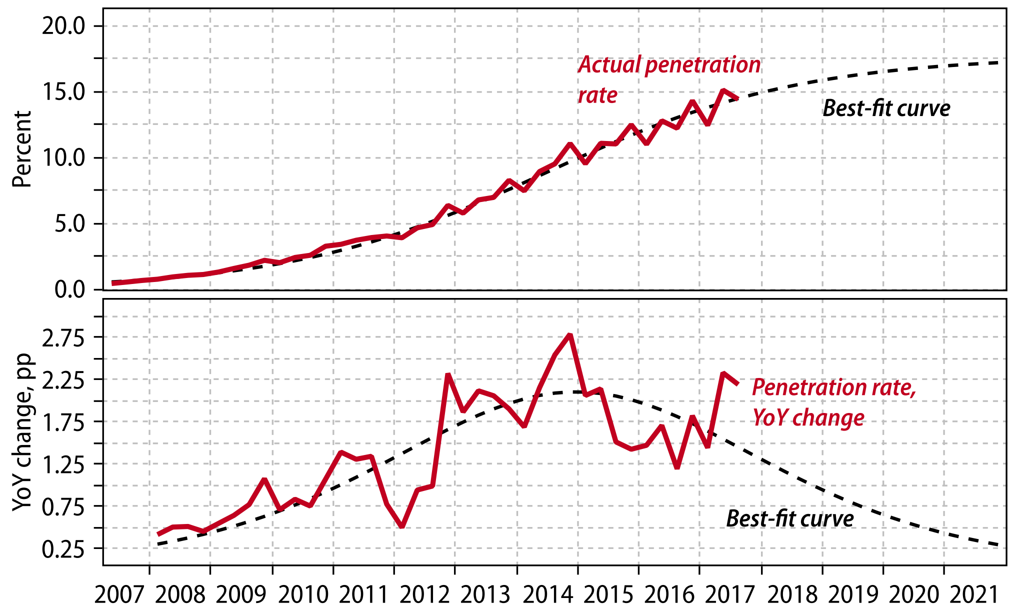
Online retailing is already past its peak growth rate

Share of online retail in total retail sales of consumer goods, NBS estimate



CEIC, Gavekal Data/Macrobond

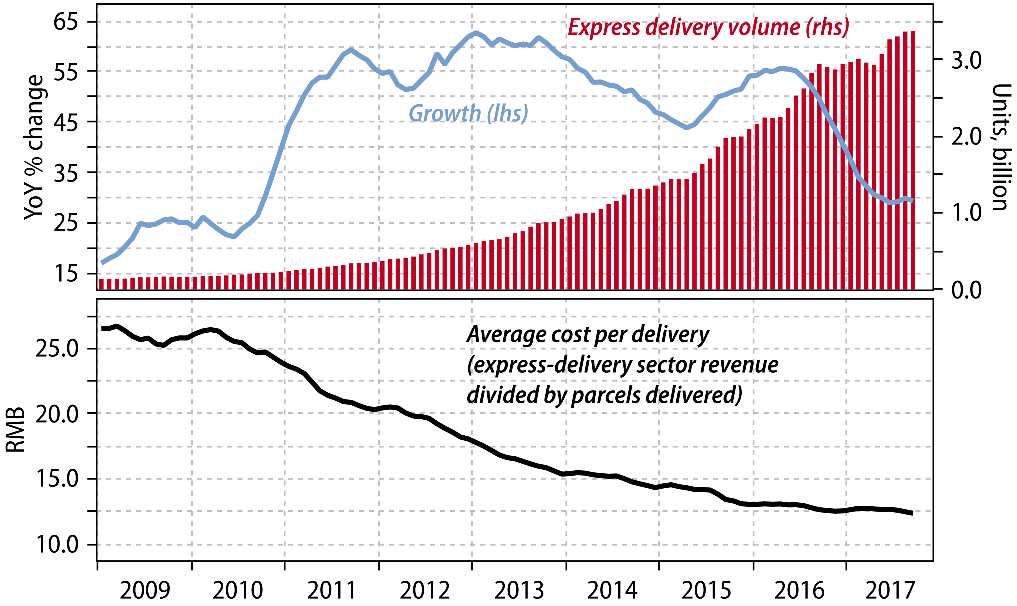
The explosive growth of online retailing has cooled some over the past two years, reflecting the fact that the market is increasingly large and mature. But there have been some stronger numbers in 2017: official online retail sales accelerated to 29% YoY growth in the first three quarters of 2017, from 26% growth in 2016, and industry giant Alibaba also reported a growth surge in recent quarters. However, I think this surge is most likely a temporary one driven by changes in promotional tactics.

The penetration of online retail, as with most new technologies, follows an S-curve of rapid growth initially and slower growth later. The curve implied by historical data shows that online retail has already passed its peak growth period. The short-term data are definitely volatile, but the underlying trend should still be for online retailing to gradually slow (while remaining faster than overall retail growth). The Chinese government is now also tightening some regulations on online retailing.

The disruption of offline retailers has passed its peak

Express delivery growth peaked as its cost bottomed

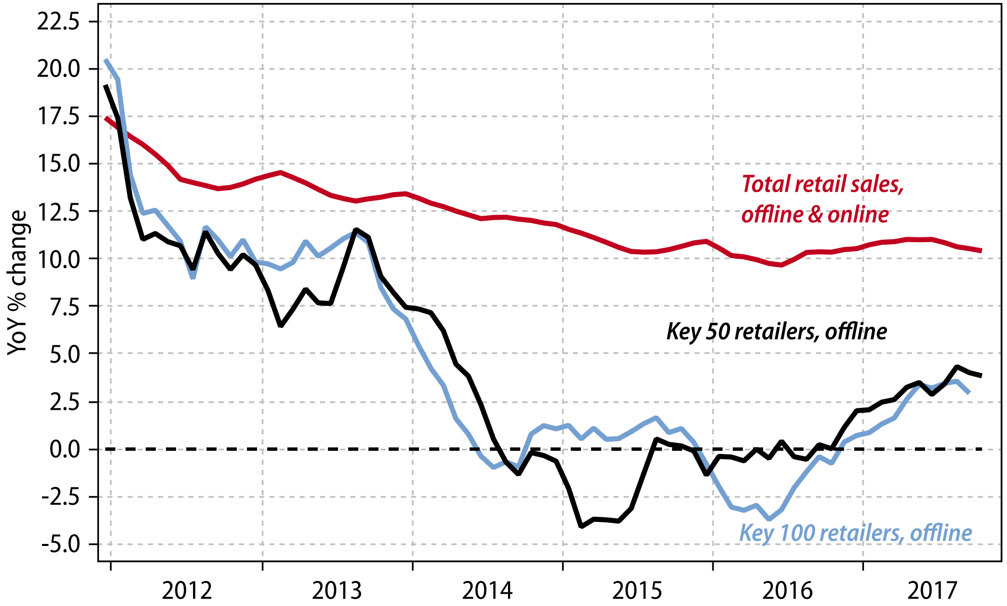
7mcma



CEIC, Gavekal Data/Macrobond

The worst time for offline retailers is over

Retail sales of different retailer groups, 6mma



Wind, CEIC, Gavekal Data/Macrobond

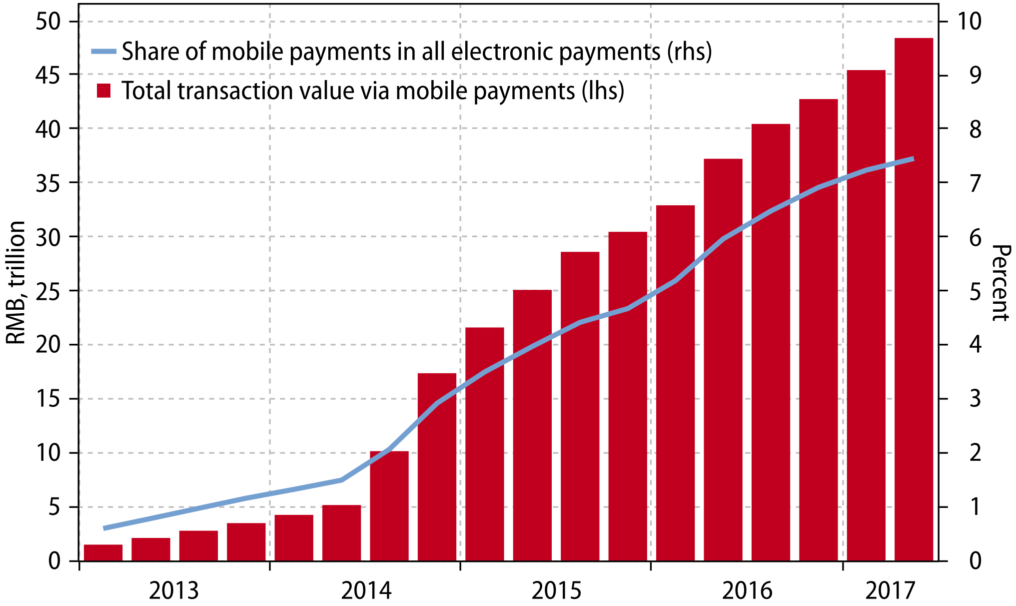
One of the factors enabling fast growth in online retailing has been the rapidly falling cost of delivering packages: the average cost per parcel fell to RMB12-13 in 2017 from RMB21 in 2011. But the decline in cost per parcel has slowed substantially since 2015, a likely indication that further productivity improvements are proving harder to come by. This stagnation will make it more difficult at the margin to attract additional users and transactions to online retailing.

The slowdown in online retail means that the pressure on offline retail channels has become less intense. Offline retailers seem to have passed their worst period, with traditional large retailers seeing positive growth again in 2017, after falling sales over 2014-2016. Online retailers are also pursuing a strategy of integrating with offline channels, which could support growth for offline businesses and blur the distinction between online and offline retail.

Mobile payments bridge online and offline retail

Surging mobile payments are linking online and offline commerce

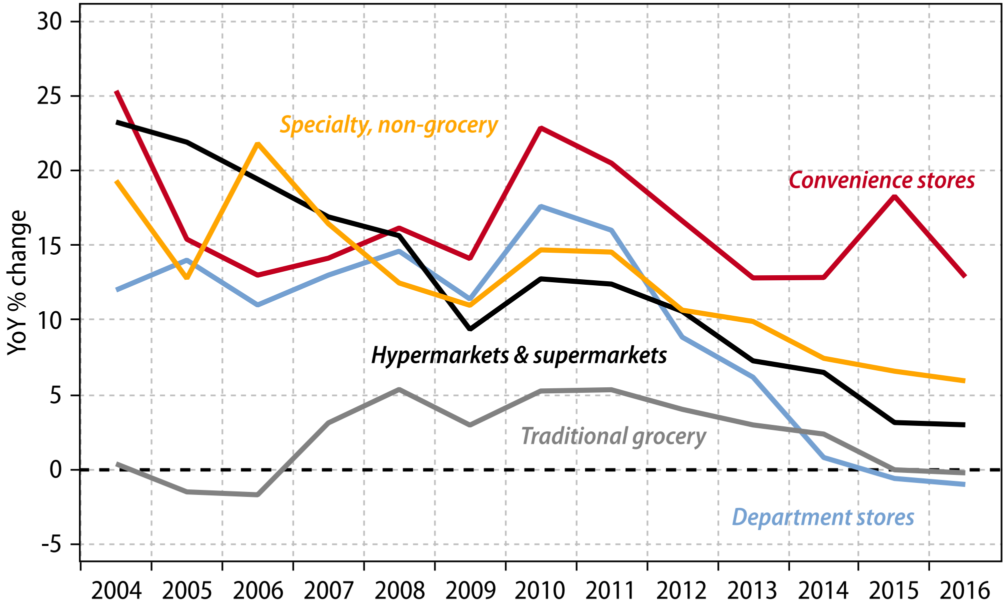
Payment through electronic channels in banking system, 1ycma



PBOC, Gavekal Data/Macrobond

Convenience stores are the fastest growing offline retail category

Annual growth of retail business by type, after tax sales



Euromonitor, Gavekal Data/Macrobond

The use of online payment options in offline retail outlets has become increasingly popular. According to the central bank, total payments through mobile terminals reached RMB100trn in 1H17, 10x the transaction value in 2013. The two leading payment service providers, Alipay & WeChat Pay, account for over 90% of the market, and are supported by over 200mn offline retailers all over China. This phenomenon has started to blur the boundaries between online and offline retail and created opportunities to mix the best of both worlds.

Among all types of offline retail business, convenience stores are the fastest-growing channel with the least substitution to online. With online retailers looking for ways to maintain high growth, they are seeking opportunities from linking up with offline channels, particularly convenience stores which can also serve as their delivery pickup stations. The retail business of the future is likely to combine the advantages of data-driven online supply chain, marketing and payment systems with offline networks of physical stores and delivery systems.

Contact and disclaimer

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