
FORGET THE TRADE WAR ALREADY: CHINA IS CUTTING TAXES

Jeff Weniger — Head of Equity Strategy

08/06/2018

The market's obsession with trade wars may finally be exhausted and priced in. Move on to the next market mover: massive Chinese tax cuts, which should aid the [WisdomTree ICBCCS S&P China 500 Fund \(WCHN\)](#) and the [WisdomTree China ex-State-Owned Enterprises Fund \(CXSE\)](#), our [passive](#) ETFs for the country.

Sure, China exported \$457 billion worth of goods and services to the U.S. in the year through June,¹ and some fraction of those exports is at risk from a deterioration in Sino-U.S. relations. But engage a drastic scenario: Lop off \$200 billion or \$300 billion from that figure. Even if that happened, most of that sum wouldn't even disappear; it would be sold elsewhere, maybe inside China, at concessionary prices. But even suspending logic and having it all vanish, is it really doomsday for China's \$14.1 trillion economy (\$25.2 trillion at [purchasing power parity](#))?² We don't want to minimize the importance of trade conflicts, but the airtime given this topic is hysterical.

When President Obama was in office, many conservatives and free-market acolytes convinced themselves he would destroy the economy, so they ignored massive [fiscal](#) and [monetary stimulus](#)—the data—and missed the equity [bull](#) market. Emotions ruled; logic lost.

Now it's happening with President Trump. Among some investors, emotions are defeating data. The recent BofA/Merrill Lynch Fund Manager Survey pointed to a trade war as the market's biggest risk. That may be because some investors so badly wish Trump to fail that, like conservatives during the Obama years, positive news is simply ignored. Forget Japan's major trade deal with the EU, ink still wet. Forget Trump's meeting with European Commission President Jean-Claude Juncker, where they agreed to work toward zero tariffs. The end is near!

Astute investors need a sober, facts-based thesis.

A Thesis without Emotion

A more realistic take on matters is that China finds itself isolated, unable to pair with Moscow in a two-country geostrategic counterbalance to the West. This forces Beijing to backtrack on intellectual property theft, inordinately high tariff levels, state subsidies and dumping, due to its weak bargaining hand.

The pain must be offset, so Beijing gives the market that which it aches for: trillions of dollars in tax cuts at the business, product and personal income tax levels. Yes, Trump's ability to stir the pot is important, but mathematics matters more.

Chinese equities are the play here.

Bold Actions

We calculate that *many Chinese will see their personal income tax liability fall by half or more, effective January 1, 2019*. Add to this our estimate of nearly \$500 billion in [value-added tax \(VAT\)](#) cuts over the next decade, with still-in-the-works business tax relief on top, which would be another \$132 billion to \$138 billion if activity grows at a 6% to 7% pace. For perspective, Beijing's Lehman-era \$586 billion spending package, hypothesized by some to be the reason the global financial crisis ended, is smaller than 2018's total announced tax cuts, if we calculate them over several years. This is this year's big story.

Income Tax Scenarios: Implications for Everyday Chinese

The proposed personal income tax code changes are staggering (figure 1). Exemptions and the minimum bounds for the 10%, 20% and 25% brackets are set to gap higher, while tuition, medical and mortgage deductions add to the savings.

Figure 1: China Personal Income Tax Code

Tax Rate (%)	Current Tax Code		New Tax Code	
	Monthly Taxable Income (CNY)		Monthly Taxable Income (CNY)	
	Lower Bound	Upper Bound	Lower Bound	Upper Bound
3%	0	1,500	0	3,000
10%	1,500	4,500	3,000	12,000
20%	4,500	9,000	12,000	25,000
25%	9,000	35,000	25,000	35,000
30%	35,000	55,000	35,000	55,000
35%	55,000	80,000	55,000	80,000
45%	80,000	--	80,000	--
	Current Exemption 3,500		Proposed New Exemption 5,000	

Source: China International Capital Corp. Table reproduced from "China Plans Income Tax Cut to Boost Consumption and Reduce Inequality," Financial Times, 7/2/18.

If these become law in October and are implemented in January, someone making CNY15,000 per month (\$2,242), a wage that is common in a city like Shanghai, where 2017 median monthly income is \$1,569, would see his or her *monthly* taxes cut by CNY1,080 (\$161).³ The person making half that amount, CNY7,500 per month, which is short of the metropolitan median, would save about \$400 per year on an income of \$13,450. This is serious.

Chinese Equity Valuations

With many Chinese equity markets hammered this year, the [S&P China 500 Index's forward P/E multiple](#) has fallen to 12.3, a sharp discount to the U.S. S&P 500 (P/E of 17.7).⁴ It trades for such a low multiple even though it has 16.6% of its weight in Tencent and Alibaba⁵, part of the FAANGs + BATs octet of market darlings.⁶

The [WisdomTree China ex-State-Owned Enterprises Index](#), a "future of China" growth index that gets rid of big monolithic arms of the Chinese Communist Party, trades for 16.8x forward earnings, also a multiple that is lower than the U.S. broad market, even though our Index is tech-heavy.

For an emotional assessment of trade war doom, consult your Facebook "friends." For a sober take, internalize trillions in Reagan-style tax cuts.

¹Source: Customs General Administration PRC.

²Source: IMF Report for China 2018 est., as of 4/18.

³Source: "China Wage Levels Equal to or Surpass Parts of Europe," Forbes, 8/16/17.

⁴Source: Bloomberg, as of 7/27/18.

⁵Please click the tickers for the holding of Tencent and Alibaba holdings in [CXSE](#) and [WCHN](#).

⁶Source: WisdomTree, as of 7/13/18. FAANGs = Facebook, Apple, Amazon, Netflix and Google parent Alphabet, which have been market leaders in recent years. BATs = the Chinese equivalent, comprising Baidu, Alibaba and Tencent.

Important Risks Related to this Article

Neither WisdomTree Investments, Inc., nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax advice. All references to tax matters or information provided on this site are for illustrative purposes only and should not be considered tax advice and cannot be used for the purpose of avoiding tax penalties. Investors seeking tax advice should consult an independent tax advisor.

There are risks associated with investing, including possible loss of principal. Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. The Funds focus their investments in China, including A-shares, which include risk of the RQFII regime and Stock Connect program, thereby increasing the impact of events and developments associated with the region, which can adversely affect performance. Investments in emerging or offshore markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. The Funds' exposure to certain sectors may make them more vulnerable to any single economic or regulatory development related to such sectors. As these Funds can have a high concentration in some issuers, the Funds can be adversely impacted by changes affecting those issuers. These Funds will be required to include cash as part of their redemption proceeds, which introduces additional risks, particularly due to the potential volatility in the Chinese market and market closures. These Funds invest in the securities included in, or representative of, their Indexes regardless of their investment merit, and these Funds do not attempt to outperform their Indexes or take defensive positions in declining markets. Due to the investment strategy of each of these Funds, they may make higher capital gain distributions than other ETFs. Please read each Fund's prospectus for specific details regarding the Fund's risk profile.

For the top 10 holdings of CXSE please visit the Fund's fund detail page at <https://www.wisdomtree.com/investments/etfs/equity/cxse>

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

Purchasing power parity : Academic concept stating that exchange rates should adjust so that equivalent goods and services cost the same across countries, after accounting for exchange-rate differences.

Fiscal Stimulus : Using fiscal policy as a tool to provide economic growth.

Monetary stimulus : refers to attempts to use monetary policy like lowering interest rates or quantitative easing to stimulate the economy.

Bullish : a position that benefits when asset prices rise.

Value-added tax (VAT) : is a type of consumption tax that is placed on a product whenever value is added at a stage of production and at final sale.

S&P China 500 Index : Comprises 500 of the largest, most liquid Chinese companies while approximating the sector composition of the broader Chinese equity market. All Chinese share classes including A-shares and offshore listings are eligible for inclusion.

Forward P/E ratio : Share price divided by compilation of analyst estimates for earnings-per-share over the coming 12-month period. These are estimates that may be subject to revision or prove to be incorrect over time.