

# THE GIPPER COMES TO CHINA

By **Jeff Weniger**, CFA, Asset Allocation Strategist

Talk of U.S. protectionism continues to dominate stock market action. With President Donald Trump focusing on the lopsided \$389 billion trade deficit with China,<sup>1</sup> the S&P China 500 Index, which is tracked by the WisdomTree ICBCCS S&P China 500 Fund (WCHN), has fallen 24% since January 26, 2018. The WisdomTree China ex-State-Owned Enterprises Index, which is tracked by the WisdomTree China ex-State-Owned Enterprises Fund (CXSE), is also down 22% from the top.<sup>2</sup>

A handful of fears have led Chinese equities down: the Federal Reserve raising rates, money markets being more heavily regulated by the People's Bank of China, fears of a property bubble<sup>3</sup> and the prospect of a trade war with the U.S. are among the leading factors. But amid all of this, few strategists seem to know or care about the Ronald Reagan-esque tax cuts announced by Beijing this year.

In fact, the lack of excitement about Chinese fiscal stimulus may be our most eyebrow-raising development of 2018—and we imagine it is just a matter of time before the market comes to appreciate the extent to which Beijing has channeled Reagan, “the Gipper.” Let the market focus on the trade war, because astute observers may note an opportunity from value-added tax (VAT) cuts and what we calculate as a *halving in personal income tax liabilities* of everyday Chinese later this year.

## SLASHING RATES FOR THE CONSUMPTION ECONOMY

In a recent blog post, “Subsidizing China’s Superpower Aspirations,” we wrote how the game plan for the country ever since Deng Xiaoping replaced Mao Zedong as Chinese leader in 1978 was to famously “bide its time,” grow its wealth and then “go out.” The last part, the going out, describes a muscled power colonizing vast territories to its south and west. The industrialized nations, constrained by guilt over their own colonial past, choose to watch from the sidelines. The purpose of Chinese colonization in the form of infrastructure investment, loans and the spreading of cultural soft power is to influence southeastern and central Asia, Africa and Latin America.

But inside its own borders, Beijing wants to transition from being “manufacturer to the world” to being a country where its own citizens ratchet up their consumption. A potential eight-year battle with President Donald Trump accelerates the urgency.

<sup>1</sup> U.S. Census Bureau, through 5/31/18.

<sup>2</sup> Sources: Bloomberg, WisdomTree. Data through 8/24/18.

<sup>3</sup> Bubble: When market participants drive stock prices above their “fair value” in relation to some system of stock valuation.

## EIGHT YEARS VS. TRUMP?

With Trump in office, the Chinese economic model built on manufacturing cheap goods and dumping them on the Port of Long Beach will have to change. Also, the days of stealing intellectual property, especially in technology, and ethical legerdemain such as “knocking off” Nike shoes and Coach purses probably are numbered. These tactics will disappear, and so too will China’s ability to claim poverty at the World Trade Organization, which has allowed it to levy higher tariffs than the industrialized economies.

We think many analysts are operating under the assumption that Trump will necessarily lose in 2020, yet his real money re-election odds are currently priced in the mid-30% range.<sup>4</sup> Beijing is no doubt doing the math, realizing that the lopsided trade arrangements of the past have little chance of surviving through this year, let alone through 2024 in the Trump-for-eight-years scenario.

The nature of the Chinese economy must change, and Beijing’s tool for accelerating that change is a two-pronged attack on VAT and personal income taxes, to spur domestic consumption.

## VAT REFORM

With Trump threatening to impose tariffs on maybe the full \$457 billion of Chinese goods and services it exports to the U.S.,<sup>5</sup> China sought pain relief in May by cutting VAT taxes on a handful of industries. Wall Street made little note of the development. According to China’s State Council, these cuts will chop the VAT burden by CNY240 billion (\$35.9 billion) this year alone.<sup>6</sup>

Since budget analysts tend to use 10-year outlooks, figure 1 shows the sensitivity analysis of the potential VAT savings for that horizon. With China’s second-quarter real gross domestic product (GDP) growth of 6.7% while consumer price inflation was 2.1% in July, about equal to its five-year average, nominal GDP growth may be around 8.8% at present. Lopping a couple percentage points off of that figure to be conservative in forecasting, it may be reasonable to foresee manufacturing output growing 6% to 7% in the coming years. If so, the cumulative effect of this spring’s cuts is CNY3,163 billion to CNY3,316 billion (\$473 billion to \$496 billion) over 10 years.

<sup>4</sup> Natural odds of victory in a square wager on a venture at 17-10 odds (his price at William Hill, the publicly-listed London Bookmaker) equals 10 divided by the sum of 17 and 10, or 10/27ths (37%). This assumes the bookmaker takes no vigorish, or premium for booking the wager, which is not the case. This means that if William Hill has set a market-clearing price on a Trump victory, true natural odds are a bit lower than 37% when accounting for the house take.

<sup>5</sup> Source: Customs General Administration PRC, through 6/30/18.

<sup>6</sup> Reuters: China to cut VAT tax rates for manufacturing and other sectors: state media, 3/28/2018.

**Figure 1: Estimated 10-Year Tax Savings, Value-Added Tax (CNY Billions)**

	Production Growth Rate										
	0%	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
2018	240	240	240	240	240	240	240	240	240	240	240
2019	240	242	245	247	250	252	254	257	259	262	264
2020	240	245	250	255	260	265	270	275	280	285	290
2021	240	247	255	262	270	278	286	294	302	311	319
2022	240	250	260	270	281	292	303	315	327	339	351
2023	240	252	265	278	292	306	321	337	353	369	387
2024	240	255	270	287	304	322	340	360	381	403	425
2025	240	257	276	295	316	338	361	385	411	439	468
2026	240	260	281	304	328	355	383	412	444	478	514
2027	240	262	287	313	342	372	405	441	480	521	566
<b>Sum (CNY)</b>	<b>2,400</b>	<b>2,511</b>	<b>2,628</b>	<b>2,751</b>	<b>2,881</b>	<b>3,019</b>	<b>3,163</b>	<b>3,316</b>	<b>3,477</b>	<b>3,646</b>	<b>3,825</b>
<b>Sum (USD)</b>	<b>359</b>	<b>375</b>	<b>393</b>	<b>411</b>	<b>431</b>	<b>451</b>	<b>473</b>	<b>496</b>	<b>520</b>	<b>545</b>	<b>572</b>

Annual Savings

Source: WisdomTree, extrapolating the Reuters citation of CNY240 billion in 2018 tax savings, grown linearly.

And that’s just the start. Income tax cuts are also being discussed, and some estimate that the total value of all tax reductions over the next 10 years may amount to \$1.5 trillion to \$2.0 trillion, equaling or exceeding the \$1.5 trillion in Trump tax cuts.<sup>7</sup>

**INCOME TAXES**

Figure 2 lays out Beijing’s plan for the income tax code. In the outline, which could be law by October and in effect for 2019, the *monthly* individual income tax exemption rises by CNY1,500 to CNY5,000. That’s just the start. Notice the huge jumps in the lower eligibility bounds for the 10%, 20% and 25% brackets. Additionally, discussions include allowing deductions for tuition, medical expenses and mortgage payments.

<sup>7</sup> Christopher Balding, “Tax Cuts Feed China’s Consuming Passion,” Bloomberg Opinion, 6/20/18.

Figure 2: 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 the “China Plans Income Tax Cut to Boost Consumption and Reduce Inequality,” Financial Times, 7/2/18.

### WHITE-COLLAR MATH

Figure 3 shows what could happen to a white-collar worker making CNY15,000 per month (\$2,242), a wage that is common in a city like Shanghai, where median income was \$1,569 per month in 2017.<sup>8</sup>

In dollars, the current regime has this person paying \$3,354 in annual taxes on yearly gross wages of \$26,901. Under the new tax code, his or her tax liability falls 58% to \$1,417, a savings of nearly \$2,000. Such numbers make Reagan look like Trotsky.

<sup>8</sup> Kenneth Rapoza, “China Wage Levels Equal to or Surpass Parts of Europe,” Forbes, 8/16/17.

**Figure 3: Hypothetical Individual Tax Liability, Wage of CNY15,000 per Month (\$2,242)**

		Old Tax Code		New Tax Code			
Monthly Gross Income (CNY)		15,000		15,000			
Exemption (CNY)		3,500		5,000			
Taxable Income (CNY)		11,500		10,000			
Marginal Rate	Amt. of Income in Each Bracket	Tax Due	Amt. of Income in Each Bracket	Tax Due			
3%	1,500	45	3,000	90			
10%	3,000	300	7,000	700			
20%	4,500	900	0	0			
25%	2,500	625	0	0			
Monthly Tax (CNY)		1,870		790		Savings	
Yearly Tax (CNY)		22,440		9,480		1,080	Savings 58%
Monthly Tax (USD)		279		118		161	
Yearly Tax (USD)		3,354		1,417		1,937	

Source: WisdomTree. 2018 tax code if the proposal of record in July 2018 becomes law. Subject to change.

Take the worker of lesser means, who makes half the first worker’s compensation. This person, who grosses CNY7,500 per month, currently has the first CNY3,500 exempted from taxes, leaving CNY4,000 subject to tax. Their liability is CNY295 per month. That same worker in the new regime doesn’t even hit the second bracket, so their liability could fall 75% to CNY75 per month. In U.S. dollars, this person who makes \$13,450 per year could witness his or her taxes cut by \$395 next year.

**WILLING THE CONSUMER IMPULSE**

Anticipating a fraying of relations with the industrialized powers, Beijing sees a ripe time to transition to a consumption-based economy, and it appears the regime is playing the “go big or go home” strategy on taxes.

Thus far, the shift to consumption is working, somewhat, but more work is to be done. While private consumption-to-GDP rose to 39.1% in 2017 from 35.6% in 2010, it is still barely half the levels seen in the U.S., where it is 69% and has been north of 60% since 1979.<sup>9</sup> But while the pace of catch-up feels slow, China’s supercharged economic growth—even in the current “slow” era—has allowed retail sales to jump 8.8% in the year to July on top of nearly 11% growth rates in the prior two years. This pace allows retail activity—in a country of 1.4 billion souls—to double every seven years or so.

<sup>9</sup> China source: CEIC Data, as of 2017. U.S. source: St. Louis Fed, as of 3/31/18.

The China of 2018 already sports superpower companies such as Alibaba and Tencent, players that are as strong and as world-changing as Google or Amazon. And with per-capita GDP of \$8,827, about equal to that of Mexico, Kazakhstan and Bulgaria,<sup>10</sup> China is still short of the middle-income range. But consumption-based companies aren't hesitating. For an idea of scale, Starbucks plans to open a new store in China every 15 hours, while Tim Hortons, the Canadian coffee brand, is expected to open "only" 1,500 stores in the country in the next decade.<sup>11</sup>

But Xi Jinping is growing impatient, seeing the transition pace as too slow. Tax cuts are the electric jolt.

### 2018 XI = 1981 REAGAN?

For adherents to supply-side economics, the philosophy that generally says that tax cuts stimulate economies, comparing Reagan's 1981 tax cuts with what may become Chinese law this October is a worthy exercise.

When Reagan was sworn into office in January 1981, the U.S. was mired in a double-dip recession. Reagan's tax changes reduced the top marginal bracket from 70% to 50% (reducing it further to 28% in the Tax Reform Act of 1986), while providing family-friendly boosts to child tax credits.

His tax reform and "morning in America" message helped the U.S. economy create 3.5 million jobs in 1983, continuing into 1984 with an average 346,000 monthly jobs added in the first three quarters of 1984, right before the November election. Walter Mondale, the Democratic challenger, didn't stand a chance, carrying just his home state of Minnesota and solidly Democratic Washington, D.C. The landslide stands to this day as the presidential equivalent of Secretariat's 31-length romp "like a tremendous machine" in the 1973 Belmont Stakes. The economic expansion persisted until the 1990 Gulf War, uninterrupted by the 1985 Saudi-induced oil price spike and the 1987 stock market crash.

China has many reasons for channeling Reagan. For one, the politburo<sup>12</sup> needs to find a way to alleviate the potential pain from a reversal in runaway home prices. According to Numbeo, the Shanghai home price-to-income ratio has risen to 44.0, about four times that of New York City (11.9).<sup>13</sup> Meanwhile, both the U.S. Fed and the Bank of Canada are tightening monetary policy, while the European Central Bank is set to end its €30 billion-per-month bond-buying program this year. Even the Bank of England may raise rates by a half a point by the end of next year, if the Wall Street consensus is correct. While all of this is happening, Trump's fists are clenched at the bargaining table.

Tax cuts make sense for Xi. Sure, his rubber-stamp National People's Congress granted him the ability to be president for life, but the Chinese Communist Party (CCP), like every autocracy, still needs to have some level of public support to avoid overthrow. For 29 years, ever since the CCP showed its true colors in Tiananmen, Beijing's social contract has been to deliver economic expansion in exchange for a lack of political liberty.

The country has stayed unified, but Xi must continue to deliver on the economic front to maintain power.

<sup>10</sup> World Bank, 2017. = \$8,903, \$8,838 and \$8,031, respectively.

<sup>11</sup> Source: Starbucks from CNBC, 12/5/17; Tim Hortons from the Toronto Star, 7/16/18.

<sup>12</sup> The executive committee and chief policymaking body of a Communist party.

<sup>13</sup> Sourced on 8/27/2018.

## THE MARKET'S FOCUS

For whatever reason, while the Trump tax cuts were met with much pomp and circumstance, nary a word is spoken about two major Chinese tax initiatives taking place this year. Money is made in markets by observing events and information that are under- or overestimated by the public, then acting. We are not sure why the Xi-as-Reagan thesis hasn't taken hold, and that means opportunity looms.

With both the U.S. and China taking a scythe to their tax codes—and some talk in GOP circles of another round of cuts if the so-called Democratic “blue wave”<sup>14</sup> doesn't materialize in U.S. midterm elections—maybe the focus should be on this environment's embrace of Reaganomics, not trade wars.

WisdomTree has two China exchange-traded funds: WCHN and CXSE. The first, WCHN, seeks to track the performance of the S&P China 500 Index before fees and expenses, so it could be used as a portfolio's sole China holding. The second, CXSE, uses our screen that dumps all companies that have more than 20% ownership by the state. It, too, seeks to cover broad China, so it could also be placed in an asset allocation as the sole China fund.

## CHINESE EQUITY VALUATIONS

With many Chinese equity markets having achieved bear market status in 2018 by falling 20% or more, equity valuations have subsided to the point that the S&P China 500 Index is trading at 12x forward earnings, nearly six multiple points south of the U.S. S&P 500, which is on offer at a P/E of 17.9.<sup>15</sup> This valuation is all the more surprising because WCHN, which tracks the index, has 16.9% of its weight in Tencent and Alibaba, which have seen their valuations rise amid the FAANGs and BATs phenomenon.<sup>16</sup>

The WisdomTree China ex-State-Owned Enterprises Index, which we believe is a “future of China” growth index because it gets rid of the big monolithic organizations that are arms of the CCP, trades for 16.0x forward earnings, also a multiple that is *lower* than the U.S. broad market, even though our Index is loaded with growth-focused tech stocks.<sup>17</sup>

Additionally, for those worried about trade conflict, the People's Bank of China has been able to stealthily fight the war via the currency market, even though it claims it isn't actively trying to weaken the currency. After appreciating relative to the greenback in 2017, the yuan hit peak strength at CNY6.269 to the U.S. dollar in April. But it has turned tail ever since, heading in the direction of CNY7.0 this summer.<sup>18</sup> Some investors are concerned that it was yuan weakness that spurred the risk aversion in markets in late 2015 and early 2016. However, note that Beijing fought capital flight because of what was a \$4 trillion foreign exchange hoard in 2014. Today, after waging that battle, it maintains a formidable \$3.1 trillion war chest if capital flight becomes an issue once again.

With everyday Chinese poised to see their taxes cut by half or more, Westerners could only wish to see such personal tax relief. The Street doesn't care. Clutch a photo of the Gipper in the cowboy hat and assess accordingly.

<sup>14</sup> Blue Wave: The theory that voters will come out in size to vote for Democrats (political color blue) in November midterm elections.

<sup>15</sup> Source: Bloomberg, as of 8/27/2018.

<sup>16</sup> As of 8/13/2018. Source: WisdomTree. FAANGs = Facebook, Apple, Amazon, Netflix and Google parent Alphabet, which have been market leaders in recent years. BATs = the Chinese equivalent, comprised of Baidu, Alibaba and Tencent.

<sup>17</sup> Source: Bloomberg, as of 8/27/2018.

<sup>18</sup> CNY6.8175 = US\$1, 8/27/2018.

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