
FORGET THE TRADE WAR ALREADY: CHINA IS CUTTING TAXES

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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.

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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.