RISCURA

January 2024: China Newsletter

China Japanification

China update

In December, China's leadership, at the Central Economic Work Conference, stressed high-quality growth and affirmed support for fiscal policies but fell short of specifying targets or concrete policy actions. Regulatory scrutiny of the online gaming sector led to a market sell-off, prompting the government to swiftly adjust its stance by approving new game titles and easing industry anxieties. Technology stocks recovered some ground in the following trading days.

- **The MSCI China and MSCI China A Onshore indices were down 2.4% and 1.3% respectively.**
- **Debt in China has stabilised following an extensive deleveraging campaign.**
- **China's economic performance has continued to lag, with the stock market facing challenges in its recovery efforts.**
- **The Chinese government has adopted a restrained approach, introducing new measures aimed at bolstering economic stability.**

Key takeaways:

- China's ability to innovate will determine if it remains a middle-income country or continues to advance.
- We argue that the Chinese economy is well placed to advance due to:
  - its short innovation cycle;
  - its huge supply of hungry entrepreneurs; and
  - its large manufacturing and consumer bases.
- China should continue to grow, although at a lower rate.
- BUT there is considerable risk and uncertainty due to piecemeal policy action, although somewhat justified by the ongoing economic reforms and employment situation.
- Policy action will be critical for the medium term.

China should continue to grow, although at a slower pace

China has grown at a remarkable 9% p.a. since 1978, benefiting from the 'catch-up premium', where emerging markets grow quickly as they adopt successes and innovations from developed countries. However, many countries fail to progress beyond a certain point often known as the 'middle income trap'. This is where a country can no longer compete internationally in standardised, labour-intensive goods because wages are too high, but it also cannot compete in higher value-added activities. Examples include Brazil, Argentina, and the Philippines.

China finds itself at this junction, and the pivotal question is whether it can continue its economic progress into the future. Innovation is key: create new products to ascend into a developed market or fail to innovate and remain stuck. China's potential to advance rests on several, promising factors:

- **An opportunity to enjoy the 'catch-up premium' through a shorter innovation cycle:**

Chinese companies continue to innovate across industries, catching up with developed nations.

Almost all Chinese innovation primarily stems from talented and hungry entrepreneurs.

Economists believe that China could potentially achieve a 5-6% annual growth rate.

Chinese companies continue to innovate and catch up with developed nations in technologies across the board. Companies are advancing up the value chain, creating leading products across industries such as MRI machines, advanced machinery, or semi-conductors, many of which are competing with their developed market peers.

- **A large and eager entrepreneurial class:**

China boasts the world's largest number of ambitious entrepreneurs driving new business ventures, and, as a result, sees vibrant venture capital success, delivering robust returns despite geopolitical and economic headwinds.

Notably, almost all Chinese innovation primarily stems from talented and hungry entrepreneurs, as opposed to large conglomerates such as those in Korea and Japan. Leading entities like Li Auto (the EV SUV manufacturer in China) and Pinduoduo (the second largest e-commerce company in China), were founded by individuals as recently as 2015, exemplifying this trend, with the latter rapidly expanding in the USA and Europe.

- **The largest manufacturing hub and consumer base:**

Chinese companies benefit from serving the world's largest consumer market, and China, as the global manufacturing hub, significantly influences supply chain dynamics across multiple industries.

Considering these factors, many economists believe that the country could potentially achieve a 5-6% annual growth rate, despite challenges such as heightened geopolitics.

While this marks a slower pace compared to its past and other emerging economies like India, this growth, applied to the world's second-largest economy, could contribute an additional 1% to global GDP annually!

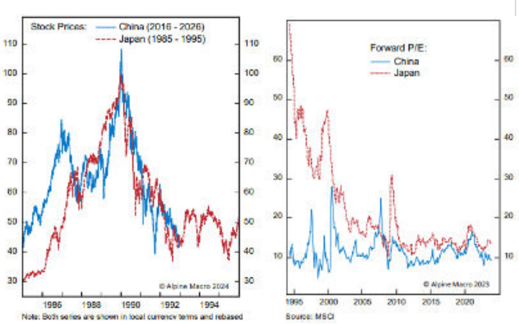
Many believe China is potentially facing challenges similar to Japan's long-standing struggles, marked by shared issues like real estate, debt, and demographics. Yet, we believe that China can steer clear of 'Japanification'.

Is China heading into 'Japanification'?

Despite the promising growth factors listed earlier, the Chinese economy is lagging, and stock markets are struggling to recover. Many believe China is potentially facing challenges similar to Japan's long-standing struggles, marked by shared issues like real estate, debt, and demographics. Yet, we believe that China can steer clear of 'Japanification' for the following reasons:

1. Japan's property and equity bubble was incomparable to China's. Although Chinese real estate faces structural issues, its overvaluation is far from Japan's peak. Japan's housing market was valued at four times the US, despite being 25 times smaller in landmass and having a smaller population.

Their listed companies' market cap was 1.5 times the US with the index P/E multiple more than 60. In contrast, China's stock market multiple is currently below 10, among the lowest of major countries.

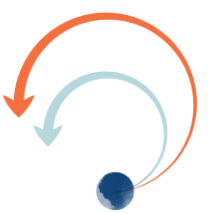


Source: Alpine Macro

2. China's debt has stabilised after a prolonged deleveraging campaign since 2017, now aligning with levels in other major economies. One key difference is the high savings rate of Chinese corporates and households on the asset side of the balance sheet. In 1991, Japan faced private debt-to-GDP exceeding 210%, coupled with a decline in net household savings to 10%. China's current private debt to GDP is comparable at around 195%, but net household savings are over 33% and continue to rise.

Chinese companies continually underscore their commitment to research and development.

Spending willingness has decreased, with nearly $6 trillion added to savings in the past 3 years.



China is undergoing a transformation, pivoting from property-driven to technology-led growth.

3. Some attribute Japan's challenges to an ageing population, but Professor Justin Yifu Lin, former Senior Vice President & Chief Economist at the World Bank, disputes this, asserting that Japan's economic struggles stemmed from stalling innovation. Unlike Japan, where innovation relied heavily on large conglomerates with poor corporate governance, private Chinese enterprises, mostly founder-led, prioritise innovation across the board. In contrast to Japan's shift towards wealth distribution, Chinese companies underscore their commitment to research and development at the start of their presentations. Furthermore, local and federal governments actively support innovation in every way they can, particularly in areas of strategic importance.

The big BUT in this argument

However, there is a big BUT in all of this. According to Alpine Macro, an economic think tank, China may follow in Japan's footsteps if it doesn't rectify its fiscal and monetary policies. They believe that self-imposed policy constraints risk a sustained growth downturn and a deflationary environment.

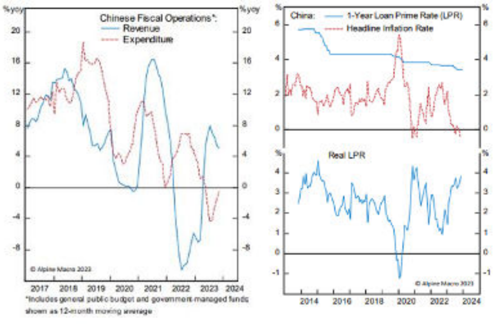
Despite an earlier-than-expected reopening in late 2022, Chinese consumer confidence remains low due to lingering COVID effects. Spending willingness has decreased, with nearly $6 trillion added to savings over the past three years. Corporations are cautious about investment and expansion amid economic and geopolitical uncertainties.

Typically, in such situations, one would expect the government to implement strong countercyclical stimulus measures, such as increased fiscal spending and a more accommodative credit environment. Without adequate policy support, the economy may endure an extended cleansing process, or even significant economic and social hardships in extreme cases.

For now, the Chinese government has adopted a restrained approach,

Without robust policy support, the Chinese economy may endure an extended cleansing process, or even significant economic and social hardships in extreme cases.

implementing measures incrementally to stabilise the economy rather than delivering a substantial boost. The graphs below illustrate that China is still in a tightening phase, where the economy is in the doldrums. In 2023, fiscal expenditures dipped below the 2022 level, despite enhanced fiscal revenue. The pace of rate cuts was much slower than the decline in inflation, resulting in higher real interest rates, even surpassing those of the United States. Home purchase restrictions and down payment ratios in major cities remain highly stringent compared to global standards, despite recent relaxations.



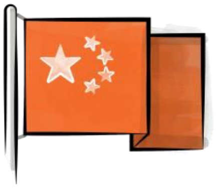
Source: Alpine Macro

So why is China refraining from aggressive stimulus measures?

A fair question to ask at this point. Is it simply a policy misstep? Some asset managers propose that China is currently undergoing an economic transformation, shifting from quantity-driven to quality-driven, and pivoting from property-driven growth to a technology-led approach.

China's success in electric vehicles (surpassing Japan as the world's largest car exporter), dominance in the global solar panel supply chain (where it controls over 80% of the global supply chain), and leadership in 5G infrastructure, high-speed trains, industrial robots, and medical devices support this transition. Even in the semiconductor supply chain, China has significantly enhanced its self-sufficiency in recent years.

China has 740 million employed individuals; the unemployment rate stands at around 5%.



President Xi's populist leadership may prompt policy shifts if social tensions continue to escalate.

We have attempted to present a balanced view of the Chinese economic landscape. We don't believe that China will end up like a Japan.

During this transition, some short-term pain is inevitable, but China is determined not to revert to relying on the property sector as the driver of economic recovery. Despite below-trend GDP growth, the Chinese government has not yet encountered high unemployment or related social unrest, which helps justify their policy stance. Currently, China has 740 million employed individuals, and the overall unemployment rate stands at around 5%, close to the pre-pandemic level. One secular factor that can explain the resilience in employment is the slowly shrinking labour force, influenced by China's demographic structure.

However, it is worth noting that President Xi's populist leadership may prompt policy shifts, and the government to step up its efforts, if social tensions continue to escalate. We have previously witnessed abrupt policy shifts in China, such as the COVID reopening. Therefore, monitoring China's macroeconomic data, including its 2024 growth target, is crucial amid potential policy changes moving forward.

Summary:

We have attempted to present a balanced view of the Chinese economic landscape. We don't believe that China will end up like a Japan. The Chinese are trying to transition away from an economic model that relies on infrastructure and the property market which has caused considerable pain in the short-term. Government policy is going to be critical for the medium term, just as it was across the world during and after the pandemic.

On the flipside, at the portfolio level we see companies continue to deliver earnings growth although their valuations are depressed. Online technology companies NetEase and Pinduoduo achieved earnings growth of 39% and 66% during the first 9 months of 2023, while their stocks are trading at a PE ratio of only 14x and 17x respectively (even lower when excluding the net cash on their balance sheets). Time to rebalance upwards?

The Chinese government has not encountered high employment despite the below-trend GDP growth.