SALT INSIGHT

August 2023

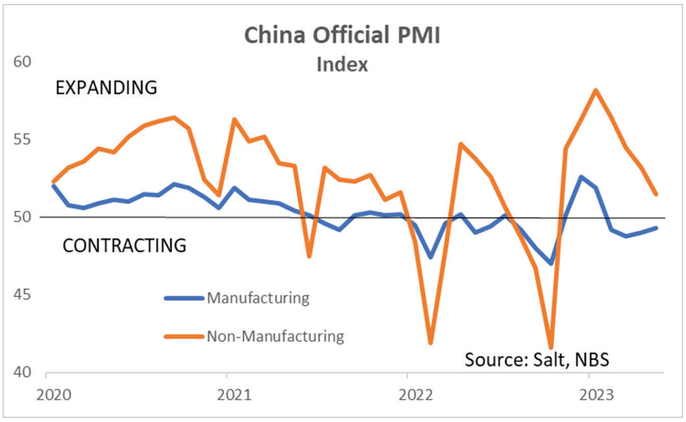
Bevan Graham Salt Economist
Greg Fleming Head of Global Diversified Funds

Worrying about China (again)

Market concerns about China are rising again as data points to a sharper than expected deterioration in the macro environment after the initial post Covid-zero bounce in the first quarter of the year.

Weakness in the goods side of the economy was not unexpected. Most economies experienced a strong pivot away from goods to services in the immediate period after the lifting of Covid restrictions, which was even followed by an element of goods deflation as supply chains were re-established. Given the Chinese economy's higher weight towards goods relative to services than many developed economies, some weakness across consumption, manufacturing and even inflation, is not surprising.

However, the weakness is becoming broader based. The non-manufacturing (services) PMI is deteriorating and appears headed towards the 50 benchmark that separates expansion from contraction. Growth in bank lending also recently hit a 17-year low.



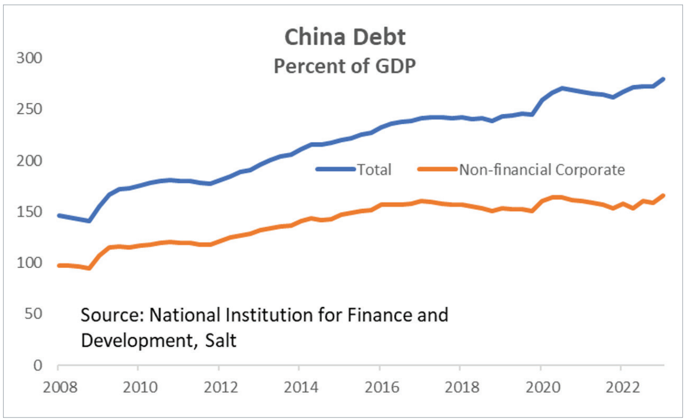
At the centre of it all is the property sector, which saw declining sales, higher insolvency pressure among developers, and a deepening contraction in new starts in the July month. The knock-on effects on property-related sectors and local government funding are likely to exacerbate deflationary pressures.

While we have seen successive and incremental property and infrastructure easing measures since the July Politburo meeting, the steeper growth slowdown means policy is probably behind the curve again. Further easing is needed, and we expect will be forthcoming.

Cyclical vs Structural – the debt problem

As always when thinking about China, it's important to distinguish the cyclical issues from the structural. While China is facing into near-term cyclical issues, the structural issues are even more problematic. These include challenging demographics, low productivity, an over-leveraged non-financial sector, and a geopolitical environment that is more likely to challenge growth in the period ahead, than to strengthen it.

China's debt problems have gained attention due to the rapid expansion of its debt levels over the past few decades. The country's economic growth was initially fuelled by a surge in borrowing, with both government and corporate entities accumulating substantial debt. While debt can be a useful tool to finance growth, China's situation has raised understandable concerns that impact market sentiment in times of stress.



The Chinese government's role in driving economic activities and supporting state-owned enterprises has led to the creation of a complex web of debt. Local governments, often responsible for infrastructure projects, have also accrued significant liabilities. This has led to worries about the sustainability of these debt levels, potentially posing risks to financial stability. According to the Bank for International Settlements, Chinese bank credit to the non-financial sector is moving towards 180% of GDP, compared to an average level for other emerging markets of around 70% of GDP. Total Chinese bond debt (sovereign and corporate) is over USD 21 trillion, having soared from USD 3 trillion in 2010, and comprises 16% of the total global bond market. The value of Chinese bond debt is now 41% of that of the US bond market, and is equivalent by value to double the total Japanese bond market. These heady Chinese debt levels have accrued quickly, raising questions about the degree of experience policy-makers and executives possess.

Efforts to curb the debt issue have included regulatory measures to control lending practices and deleverage the financial system. However, managing this process without disrupting economic growth is a delicate task. Addressing China's debt concerns requires a multifaceted approach, involving structural reforms, improved transparency, and a focus on promoting sustainable growth.

Focus on the property sector

China's property sector faces several pressing challenges. A history of high real estate price inflation, fuelled by speculation and demand, have led to housing affordability issues, particularly for the younger population. This has raised concerns about social inequality and the ability of citizens to secure adequate housing.

Additionally, the sector's reliance on debt for financing, often through shadow banking channels, has contributed to systemic financial risks. Local governments heavily depend on land sales for revenue, creating an incentive for continuous property development, even in the face of oversupply in some regions.

Regulatory interventions aimed at curbing speculation and controlling debt have led to market uncertainties and fluctuations. Striking a balance between reining in speculative excesses while ensuring a stable property market remains a considerable challenge for Chinese policymakers.

The intricacies of these issues require a comprehensive and strategic approach to ensure sustainable growth, address social disparities, and manage potential financial vulnerabilities within China's property sector.

Geopolitics are challenging

Rising geopolitical challenges present significant hurdles for the Chinese economy. Trade tensions and competition with other global powers impact export markets and supply chains, potentially dampening economic growth. Stricter foreign investment scrutiny may hinder access to key technologies and resources.

Political friction could deter international investors and disrupt initiatives like the Belt and Road. Dependence on critical sea routes exposes vulnerabilities. Moreover, divergent ideologies strain diplomatic ties, complicating international cooperation.

Balancing national interests with global integration becomes intricate. Navigating these challenges requires adept diplomacy, diversification strategies, and domestic innovation to sustain China's economic momentum amid an evolving international landscape.

We need to remember China is "different"…

Whenever we think about China, particularly when it comes to policy responses, we need to remind ourselves that you can't think about it the way you might think about a free-market economy.

A free-market economy thrives on minimal government intervention, where supply and demand largely dictate prices and allocation of resources. On the other hand, the Chinese economy is characterised by a unique blend of state control and market forces.

The Chinese government actively shapes economic policies, guiding industries and investments to achieve strategic goals. State-owned enterprises play a substantial role, often receiving preferential treatment and support, which contrasts with the level playing field of a free market. In China, the State can inject emergency liquidity, massage State-owned enterprise debt servicing capability, and even re-characterise debt as equity by fiat and compulsory re-structuring, to defer or avoid defaults.

In this way, China's approach to property rights, intellectual property, and regulatory practices diverges from those of a traditional free market. The government's influence over these aspects impacts business operations, foreign investments, and trade relationships, making comparisons with a free-market system complex.

Foreign exchange controls, censorship, and government-backed initiatives like "Made in China 2025" further underscore the disparities between the two economies. While China has experienced remarkable growth under its unique model, there are valid criticisms regarding transparency, fair competition, and human rights concerns.

…and the strategic focus is changing

In recent years, China has undergone a transformative economic shift, pivoting from a model heavily dependent on exports and investment to one that emphasises common prosperity and self-sufficiency. This transition reflects the nation's commitment to fostering more balanced and sustainable growth.

China's emphasis on common prosperity aims to reduce income inequality, enhance social welfare, and improve the overall quality of life for its citizens. This involves targeted policies to uplift disadvantaged regions and marginalised populations.

Simultaneously, the nation is strategically pursuing self-sufficiency in key industries to bolster its resilience against external shocks, as demonstrated by efforts to boost domestic technological innovation, agricultural production, and critical supply chains. Investors and exporters must be aware that conditions in 2030s China will be very different to those in 2000-20 China, and adapt accordingly.

Policy outlook

The People's Bank of China has already started to cut interest rates. This supports our view that the authorities will step up counter-cyclical easing efforts to stabilise aggregate demand in view of sluggish July economic data and renewed liquidity issues of some developers. We believe more coordinated monetary, fiscal, and property easing measures are needed to enhance pass-through of policy easing.

We expect further relaxation of housing purchase restrictions in tier-1 cities, additional fiscal support to boost infrastructure, and targeted tax cut for high-end manufacturing in the next couple of months. The authorities may also accelerate measures to address local debt risks (such as debt swaps), ahead of the Third Plenum this northern hemisphere autumn.

Two scenarios exist for addressing China's debt burden going forward, one of which is more disorderly than the other, but both of which will result in suppressed potential economic growth rates.

In the disorderly scenario, the authorities allow property developer defaults and bankruptcies. The risk is that doing so will spill over to China's banking sector and reduce confidence in the country's financial system. Alternatively, and probably more orderly if managed well, China actively tries to deleverage the economy as it did in the 2015-2016 period. In either case, credit expansion has been key to China's growth, and assuming borrowing slows, future growth rates will be negatively affected.

Biggest risk is a policy mistake

The proviso "if managed well" in the section above is a helpful reminder that the most significant risk to the Chinese economy lies in the potential for a policy mistake by its leadership. Given the complexity of China's economic landscape and its global interconnectedness, decisions made by policymakers can have far-reaching consequences. A misstep in managing issues like debt, market liberalisation, trade relationships, or financial regulation could lead to unintended disruptions.

For instance, overly aggressive measures to tackle debt might stifle economic growth, while hesitating to address structural issues could exacerbate financial vulnerabilities. Sudden shifts in economic policy could also impact investor confidence and global markets. As China's economy becomes increasingly influential on the global stage, the ramifications of any policy errors could extend beyond its borders.

To mitigate this risk, a cautious and well-coordinated approach is crucial. Balancing short-term priorities with long-term stability, fostering transparent communication, and implementing reforms in a gradual and strategic manner can help the Chinese leadership navigate complex challenges while minimising the potential for policy-induced disruptions.

Investment implications

The rapid growth of the Chinese bond market, the introduction of the Bond Connect exchange in 2017, and the inclusion of Chinese debt in global bond indices since 2019, mean that international investors need to monitor Chinese developments closely.

China's fixed income markets have grown to the point that they now constitute a large and important part of global capital markets. Chinese bonds can now constitute 9 or 10% of Global Bond Index- based International Fixed Income portfolios, issued through the large global ETF and Index-benchmarked investment companies.

In addition to maintaining elevated awareness required to monitor human rights, environmental and governance risks, investors simply must be aware that a 10% portfolio holding of Chinese and renminbi (CNY) denominated debt securities introduces distinctive performance and credit risks. We consider active management absolutely critical in this regard, and our own view is that slavishly following a 10% global bond benchmark allocation to China is probably too aggressive, given the uncertainties and the vulnerabilities emerging in that market.

Some investors drawn to Chinese bonds because of their higher yields (particularly during the "global hunt for yield" earlier this decade) now need to reckon on the risks described above, which are likely to generate choppy bond returns from China, even if domestic deflationary forces should (at least in theory) increase the capital value of these bonds. Emerging market bond investing is a tricky, specialised and volatile arena, and only investors comfortable with an unusual level of volatility and credit risk recourse should consider investing in funds with substantial Chinese debt market holdings.