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Investing for a
world of change

China: Structural and cyclical challenges present opportunities

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The fast view

- Structural and cyclical headwinds have impacted various areas of China's economy.
- Chinese authorities are addressing these challenges by adopting targeted policy measures.
- We expect a more benign outcome for the Chinese economy in the coming years, versus a very pessimistic consensus.
- Real estate's share of the economy will decline, and the banking system will absorb losses.
- Digitalisation will see increased penetration; medical technology will be supported by an ageing population; and certain financial institutions will benefit from state efforts to channel savings from real estate into capital markets over time.
- We are capitalising on these opportunities in the Ninety One Global Strategic Managed Fund. Over the last 18 months, we have been building new positions or increasing our exposure to strong businesses in areas that should benefit from structural tailwinds and increasingly loose policy.

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China faces a number of structural headwinds, which are well recognised by investors and Chinese authorities. The primary structural challenges are fourfold: a real estate imbalance, a local government and state-owned enterprise leverage imbalance, weakening demographics and geopolitical headwinds.

Before looking at each of these in turn, we believe it's important to remember that China is a command economy with a relatively closed capital account. As a result, Chinese authorities broadly control the flow of money and credit across the economy by telling the big state-owned banks how much to lend and to whom they must lend. This differs from capitalist economies where central banks raise and lower interest rates to impact the cost of money and credit and, therefore, its flow. Here, banks and other profit-maximising private participants decide how much to lend and to whom. Therefore, a default in China is typically a policy decision.

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China also enacts what authorities refer to as "cross-cyclical policy", interpreted as "taking action sooner, in smaller steps and with a focus on the longer term". In other words: taking short-term pain for longer-term gain and seeking to manage identified imbalances lower over multiple cycles. This drives China's regulation cycle, which has followed a pattern over the past decade: When the economy is doing well new regulations are introduced to address structural issues, and when the economy is weak, prior regulations are often repealed to an extent as authorities seek to boost confidence. China's economy and policy dynamics are therefore quite different to that of the vast majority of other economies around the world.

Let's now turn our attention to China's structural challenges and their impact on various sectors of the economy.

Mounting real estate woes

Chinese authorities identified the real estate market as a key issue some time ago. After a decade of rapid growth, real estate investment as a percentage of GDP peaked in 2014 at just over 14% (at the end of 2021 it was 13% of GDP), according to IMF data. China's objective is to manage this sector lower over multiple cycles, in line with its "cross-cyclical policy". This means that the real estate sector has a significant headwind in front of it versus other areas of the economy. Essentially, when times are good, authorities will likely clamp down on it and when times are tough, they are going to seek to stabilise the sector but stimulate and grow other areas of the economy that they want to support. As a result, we should see real estate shrinking as a percentage of GDP over the longer term. This is therefore not a sector in which we want to invest.

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The current down cycle in real estate is policy driven – in late 2020, the "three red lines" policy was introduced for property developers to force a reduction in debt levels and an increase in liquidity. This was coupled with broader macroprudential regulations limiting the likes of multiple home purchases and increasing loan to value ratios.

In line with the policy pattern described above, as times have got tough for the economy over the past year in particular, Chinese authorities have been busy repealing many of the macroprudential measures and providing targeted stimulus with the objective of stabilising the real estate sector. We expect authorities to do what it takes to achieve stability in the sector in the near term. But don't be surprised if there is another clampdown on the sector in the years ahead, and then again in the years after that.

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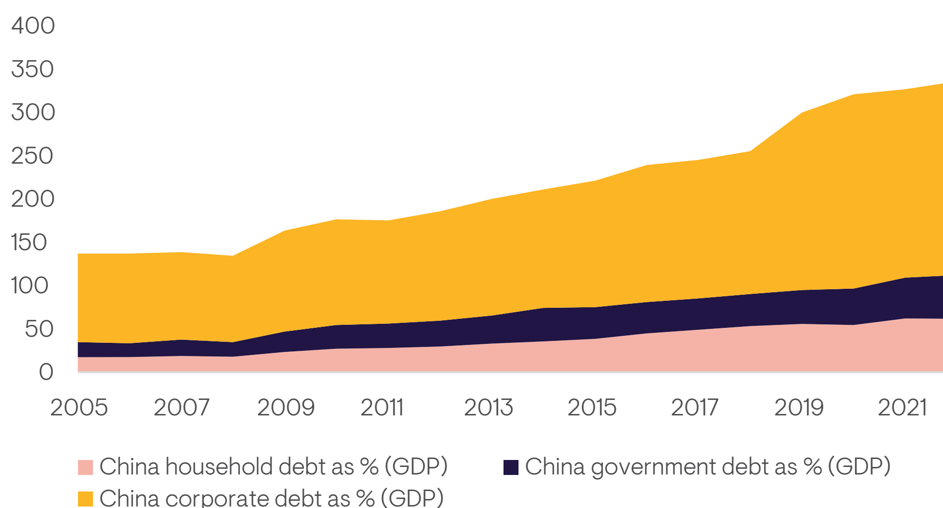
Bailouts affecting the banking sector

Another key imbalance is local government and state-owned enterprise leverage. Again, this is well known to authorities, and they clamped down hard on this through the first part of 2021 in seeking to address off-balance sheet liabilities or "hidden debts". This has without doubt contributed to weaker growth in recent years through reducing the spending of local governments. At July's Politburo meeting, Chinese authorities pledged to "implement a comprehensive debt solution" for local governments. In recent months, debt swaps have been announced for a number of provinces, and state banks have been told to do the same now more broadly. This is effectively a refinancing of debt, extending maturities at much lower interest rates. It is a bailout and will allow local governments to continue to function, but it will reduce the profitability of Chinese banks – another sector to avoid.

Figure 1: Breakdown of China's debt



Source: Bloomberg, December 2022.

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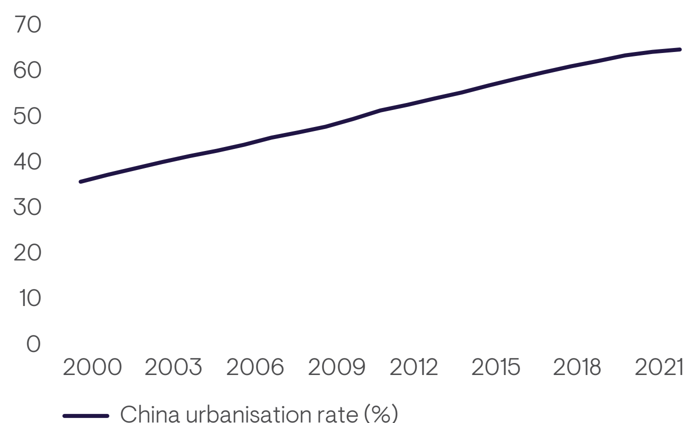
Weakening demographics put spotlight on productivity

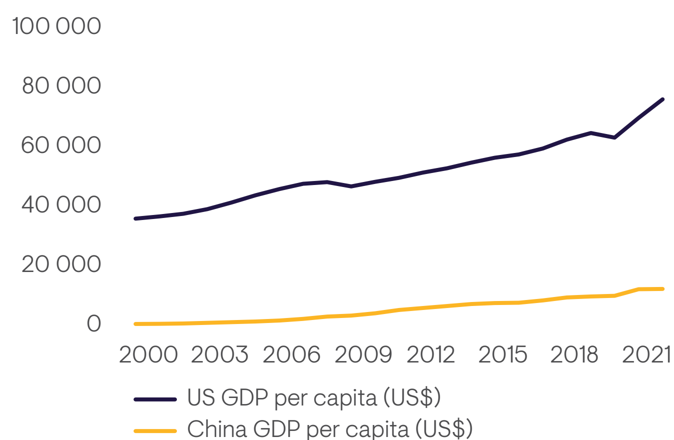
Demographics also represent somewhat of a headwind on a forward-looking basis versus the past, with the overall population having peaked and the working age population beginning to decline. One counter to this is the prospect for further urbanisation, with China's urbanisation rate standing at close to 65% at the end of 2022 and the majority of developed economies having urbanisation rates of 70-90%. Our central case would be that these forces largely offset one another, making demographics neutral for the rest of this decade. It is therefore productivity gains that will be required to drive growth going forward. China is coming from a low base in terms of productivity, with the average income per capita being a little over $12 000 vs. over $75 000 in the US, for example. When Japan's population peaked in the early 1990s, per capita incomes exceeded that of the US at the time. Chinese authorities know this, and it's a key reason why they have been seeking to address monopolistic behaviour and are directing stimulus at technological development and science to drive productivity gains.

Figure 2: China's rapid urbanisation



Source: Bloomberg, December 2022.

Figure 3: Productivity gains key to drive Chinese growth

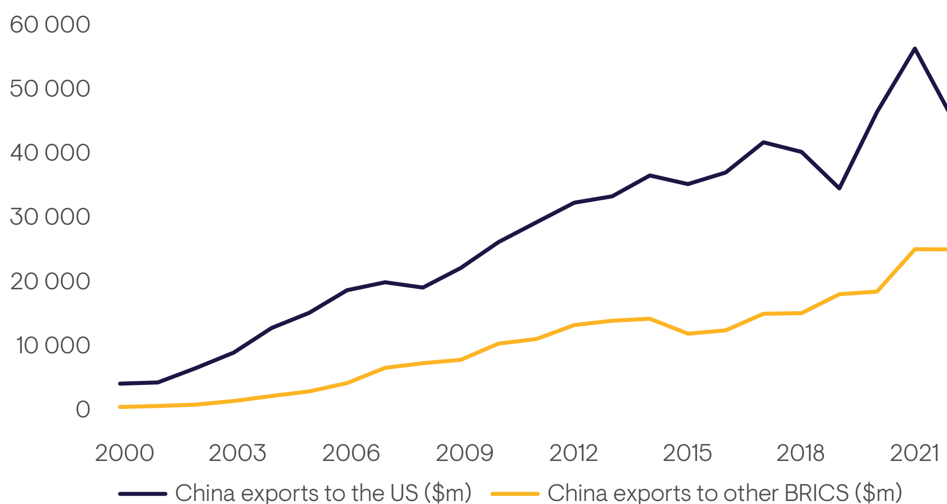


Source: Bloomberg, December 2022.

Geopolitical headwinds

"De-risking" by the developed world in recent years and the reworking of supply chains have reduced foreign direct investment into China and exports to the US, for example. Our central scenario going forward is a multi-polar world, where connectivity between the developed world and China is reduced, but decoupling is impossible due to the degree that economies are interconnected. While this is a headwind for Chinese exports to much of the developed world, trade with other countries around the world has been rising sharply. The IMF estimates for the G7 countries vs. BRICS countries (pre-expanded) place their share of GDP, at purchasing power parity, now at 29.9% vs. 32.1%, respectively, in 2023. As a result of the increasing importance of countries outside of the G7, Chinese exports have continued to rise in recent years and remain stable as a percentage of global exports.

Figure 4: Chinese exports resilient as companies find new terrain



Source: Bloomberg, December 2022.

So, while China faces some material challenges, it's important to remember that it's a command economy with a relatively closed capital account. Therefore, there is no reliance on the kindness of strangers to fund its economy, unlike many other countries around the world. This affords authorities more control in seeking to manage imbalances than elsewhere, in that they can continue to provide liquidity and credit to areas of the economy in need, and defaults are policy decisions. Chinese policy makers have also shown that they are pragmatic, and we wouldn't be surprised to see more inventive policies if required.

An improving outlook – who will be the winners and losers?

As we have detailed here, we expect a more benign outcome for the Chinese economy over the medium term. Economic growth will continue to moderate, but productivity gains should drive growth. While some areas of the economy will remain under pressure, others should thrive. For example, the real estate sector will be in decline (as a percentage of GDP); the banking system will be required to absorb losses, but per capita income growth will support ongoing trends in premiumisation and localisation; digitalisation will see increased penetration; medical technology will be supported by an ageing population; and certain financial institutions will be beneficiaries of state efforts to divert future marginal savings from real estate into capital markets over time, through the likes of pension reform.

Over the last 18 months, we have been building new positions or increasing our exposure to strong businesses in these select areas as policy has become increasingly loose. In the Ninety One Global Strategic Managed Fund, such businesses include AIA Group (a high-quality life insurance business), Contemporary Amperex Technology (a world-leading lithium battery producer), Wuxi Lead Intelligent (a leader in battery equipment technology), Midea (a major appliance manufacturer), Shenzhen Mindray Bio-Medical Electronics (China's leading medical devices and solutions provider), Tencent (a global technology giant), NetEase (a major internet technology company) and East Money Information (China's leading online brokerage and mutual fund sales platform). They have been on offer at sale prices due to the deep degree of concern and pessimism amongst investors around some of the macro challenges described above. We're reminded of an old saying that "a sale in financial markets is the one sale that no one wants to go to".

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