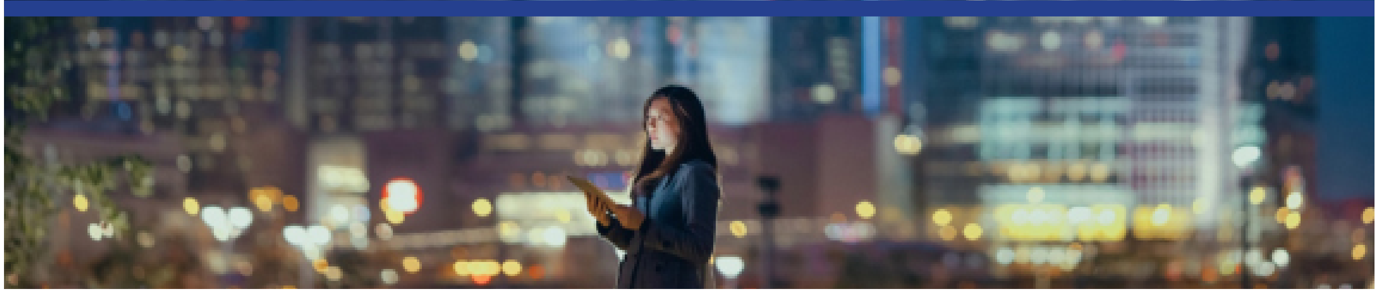

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CIO Strategy Bulletin

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China's Economic Distress and its Implications (Part 1)

Summary

- China's equity markets are down 20% from their high of this year and 54% since Feb 2021. Global and domestic investors are wondering what caused China's major change of fortune and what can be done to reverse it.
- Over the past 3 years, China's current administration has been willing to derail national champions in the name of "common prosperity". From e-commerce to online education to car-hailing, China has impacted corporate decision-making, sacrificing rapid growth in revenues and profits for greater state control. As technology emerged as a national security issue for the West, Western governments sought to isolate their markets from China's tech products. Finally, China's alignment with Russia over the Ukraine war caused foreign direct investment to plummet.
- At the center of China's malaise is a growing real estate crisis. China's highly indebted property developers seem certain to drive a wave of corporate defaults. More than 700 unfinished projects await completion nationally.
- China has not taken sufficient actions to boost domestic consumption and make targeted investments in growth industries. While we don't believe this will impact 2023's overall economic growth rates significantly (as much as many assume), it risks a spiral of debt and deflation if its policies do not spark a recovery through 2024.
- Any procrastination in stimulating China's economy risks self-reinforcing negative economic effects. This may result in a "paradox of thrift". As households seek to protect themselves by securing their balance-sheet resources, the economy may collectively face insufficient demand causing government and bank debt burdens to rise disproportionately.
- Many have argued that the disinflationary impulse of Chinese exports on US consumer prices during the past two decades had already run its course. If China does not turn around, it would be another strong factor weighing against the popular view that the US is facing a higher long-term trend rate of inflation.

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China's Economy is in Trouble

After 2021's "post-Covid", world-leading 8.5% gain in real GDP, China set new lockdowns. Markets expected a similar growth burst when China lifted all Covid restrictions unilaterally in November 2022. But that second economic acceleration proved illusive. With local equity markets down 20% this year and 54% since Feb 2021, global and domestic investors are wondering what caused China's major change of fortune and what can be done to reverse it.

No major economy pivots from high growth to low growth in a flash. From 1990 – 2022, China's national infrastructure development, real estate to support the migration of 619 million Chinese to urban centers and financing to export manufacturing companies capable of competing on the world stage led to real GDP growth averaging 8.9% per annum. Average urban incomes rose from $428 to $16,290 over that time[1]. Yet, in 2023, China is likely to see GDP growth of 4%-5% and barring a radical change in policy, the prospects for 2024 look worse.

Over the past 3 years, China's leadership has confounded even the most bullish China optimists. The current administration has been willing to derail national champions in the name of "common prosperity". From e-commerce to online education to car-hailing, China has impacted corporate decision-making, sacrificing rapid growth in revenues and profits for greater state control.

At the same time, China underestimated the will of its trading partners, like the US, to enforce the protection of intellectual capital and weaken economic links for stepped up security. As technology emerged as a national security issue for the West, a second fissure developed when Western governments sought to bifurcate markets for advanced technologies. With China rhetorically siding with Russia after the invasion of Ukraine, trade deteriorated further and foreign direct investment in China has plummeted.

China's Immediate Challenge

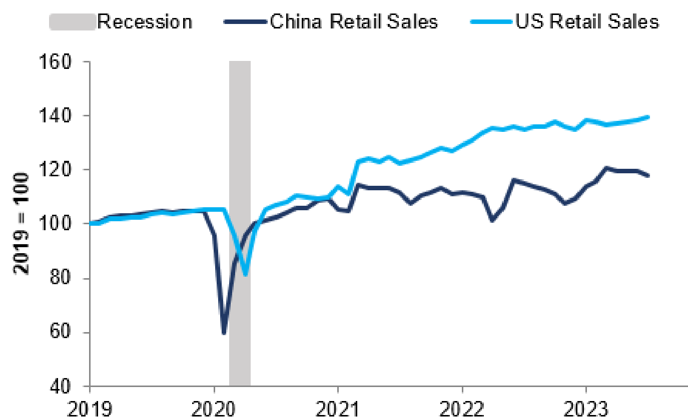
Like most economies, China's exports have weakened sharply in 2023 following an initial post COVID boom let (**Figure 1**). Gross merchandise exports are nearly 19% of China's GDP – nearly 3x larger than in the US. To make up for this, China was counting on rapid domestic demand. Instead, China's consumers are showing great caution in spending. In recent months, China's retail sales growth has been lackluster while household savings have actually increased (**Figure 2**). This demonstrates the growing lack of confidence consumers have in their future.

One might have expected China to pull out all the stops when the economy's dismal second quarter results became clear. Actions to boost domestic consumption and make major targeted investments in growth industries would evidence China's strategy of industrial leadership. But this has not materialized. Instead, China has made small gestures to lower interest rates and provide more market liquidity. This has not boosted consumer or business confidence.

[1] Source: Haver Analytics and China National Statics Bureau

Figure 1: China and US: Merchandise Exports Year over Year

Figure 2: US Retail Sales Have Risen Faster Than China's Sales Since COVID First Struck



Source: Haver analytics though August 2023. Shaded areas are recessions.

China's Real Estate Crisis Continues to Build

Real estate has historically played a major, positive role in the growth of family wealth for the Chinese. Rather than investing in stocks, homes have been a rising, safe store of value.

The current housing downcycle began in 3Q 2020 and has just entered the 12th quarter, the longest downturn on record. The long and deep contraction has had material impact on the Chinese economy which relies on real estate for about a quarter of China's GDP. The sector's economic and social importance means global investors closely monitor housing data and policies to assess domestic consumption and industrial activity.

China's loose lending policies allowed real estate developers to build too many residential units across hundreds of its largest urban centers, many in cities that won't find demand. Now, China's highly indebted property developers seem certain to drive a wave of corporate defaults. More than 700 unfinished projects await completion. Many purchases are financed by individuals who fund construction with periodic deposits. But even more are speculative units funded by state-sponsored banks and bond issuances.

No Walk in the Country Garden

The recent escalation in China's real estate crisis revolved around Country, Garden, once China's largest developer by contracted sales between 2017-2022. The company has 3,121 developments in China and maintains a large landbank that covers 1,425 locations of which 90% are in China's most overbuilt Tier 3 & Tier 4 cities[2]. Lower tier cities are seeing the worst of the price and sales declines, adding massive pressure on developers who depended on fast turnover in those cities. The local government finances in lower tier cities are also more dependent on the real estate market, and are more at risk if no effective policies are implemented to ringfence the debt. As such, Country Garden's woes have increased fears of systemic contagion.

Country Garden had record turnover of CNY 551bn (USD $78bn) on a gross basis in 2022. Like other builders, sales are now contracting severely, sinking prices. (**Figures 3 & 4**). Recent estimates suggest that home prices in China are down more than 20% on average with more than 521 million square meters of units "on the market" (**Figure 5**).

Of Country Garden's USD $200 billion liabilities about half are deposits received from home buyers, 30% are accounts payable and the remainder are interest bearing debt, including onshore and offshore loans, onshore and offshore loans and bonds. Country Garden has missed two-dollar bond coupons due 6th August 2023, a strong indication of the company's rapidly

[2] City tiers are a common way for observers to classify Chinese cities according to their size and level of development. While there isn't an officially defined criteria, there is broad agreement that there are 4 tier 1 cities, about 30 tier 2 cities, about 70 tier 3 cities, while the remainder of China's 613 cities are of lower tiers.

deteriorating liquidity. Adding to concerns that a restructuring may be imminent. Once a developer experiences a negative credit event, homebuyers' confidence tends to be severely hampered., making it even more difficult to generate cash flow.

Figure 3: Tier-3/4 Cities Primary Sales by GFA

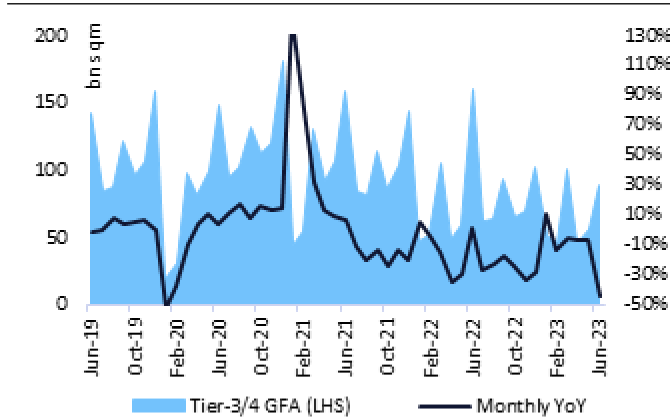
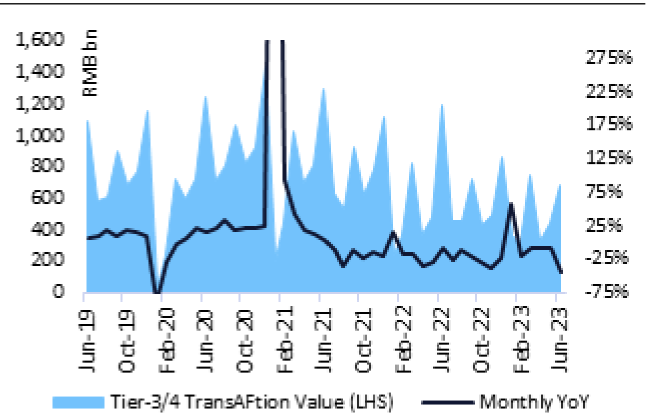
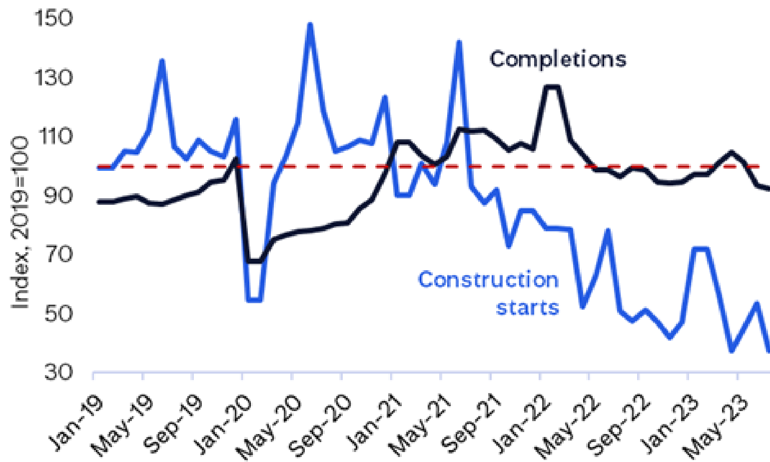


Figure 4: Tier-3/4 Cities Primary Sales by Transaction Value



Source: CRIC, as of August 19, 2023

Figure 5: Construction starts continued to fall



Source: CRIC, as of August 17, 2023

What the Real Estate Crisis Means to China

Fixed asset investment in China is more than 40% of GDP. With exports down and consumer spending cooling, China's economic outlook is highly dependent on a turnaround. Chinese authorities have signaled a sharp easing of previously restrictive conditions to dissuade property speculation. However, the public has not responded with a turnaround in spending. While we don't believe this will impact 2023's overall economic growth rates significantly (as much as many assume), it risks a spiral of debt and deflation if its policies do not spark a recovery through 2024.

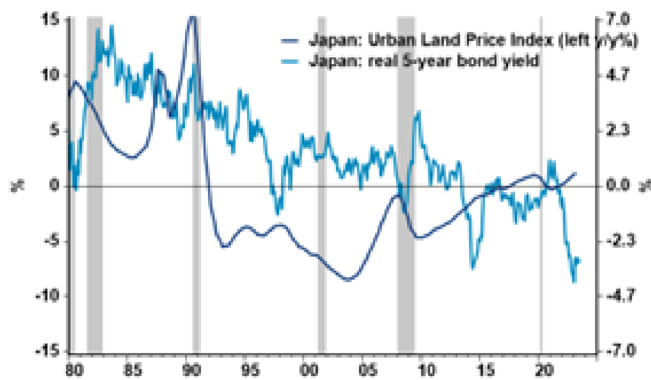
Historical Precedents in the US and Japan

Prior to and following the Global Financial Crisis, it took four years for US real estate investment to bottom following an over-development binge. The US benefited from bankruptcy and restructuring processes available through its legal system. The federal government also provided capital to major banks to allow them to survive the extensive write-offs necessitated by their bad loans. And many bondholders in the US took extensive losses. Yet, along with a radical easing of monetary policy, including zero interest rates, the decisive US actions led to a reflation of real estate prices and a gradual normalization of inflation across its economy.

The US also heeded of the lessons learned from the period of Japanese deflation that followed the bursting of its property bubble in 1989. Japanese officials responded cautiously to their crisis to avoid boosting asset prices. For many years, half-hearted small fiscal easing steps were taken and withdrawn. Japan then suffered a mild deflation for most of two decades until far stronger easing steps were finally taken about 10 years ago (**Figure 6**).

Japan's bubble at the inception of its crisis and the situation in China are not identical. There are material differences in banking, financial linkages to the world and the country's relative state of economic development. Japan's property prices surged far more in the 1980s than China's have over the last decade. And the difference in equity market valuations is far more stark. At its 1990 peak, Japan's equity market was nearly 45% of the world's total market capitalization. In 2021, China's was just 5% of the world's total equity value (**Figure 7**). When Japan's equity bubble burst, it was trading at roughly 8x the value of China's stock market, already down 52% from its 2021 peak (**Figures 8-9**).

Figure 6: Japan Property Prices Crashed in 1990, Policy Rates Only Fell to 1% in 1995, Leaving Real Yields High



Source: Haver analytics through August 15, 2023.Shaded areas are recessions. Past performance is no guarantee of future results. Real results may vary

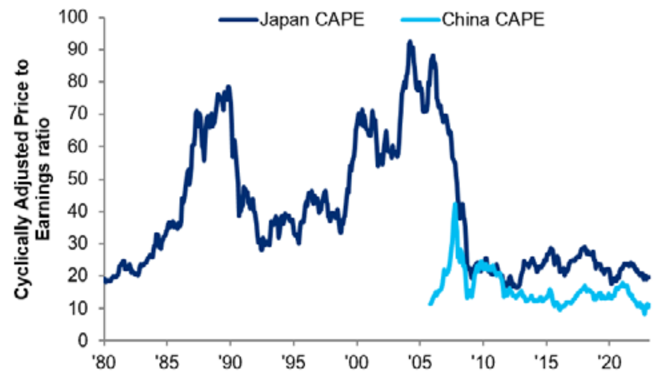
Figure 7: China vs Japan Equity Market as % of World Market Capital

Source: MSCI, Haver analytics through August 15, 2009. Past performance is no guarantee of future results. Real results may vary

Figure 8: Japan vs China Equity Market: Compare 1980s to 2010s

Source: MSCI through August 15, 2009. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Figure 9: Japan vs China Equity: Cycle Adjusted Price/Earnings



Source: Haver analytics through August 15, 2009. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary. The CAPE ratio is a valuation measure that uses real earnings per share (EPS) over a 10-year period to smooth out fluctuations in corporate profits that occur over different periods of a business cycle

China's Policy Response

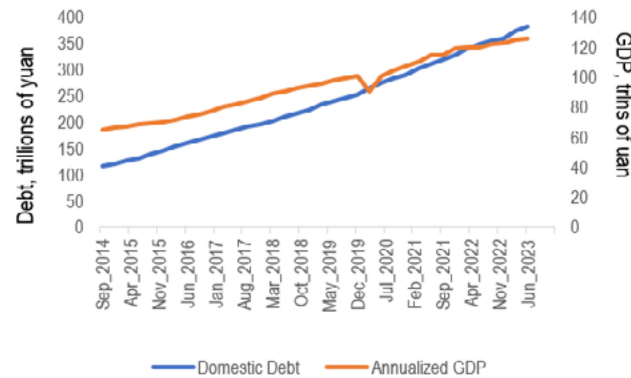
The lessons of Japan (and the US in the 1930s) should be quite clear to the Chinese government. Unless policymakers get ahead of deflationary expectations and ease forcefully, a hard, painful deleveraging becomes likely. This would cause healthy parts of the Chinese economy to be dragged down along with the industries in need to fundamental restructuring.

We believe any procrastination in stimulating China's economy risks self-reinforcing negative economic effects. Yet, China's policymakers are seeking to avoid rewarding mistakes with "bailouts." They continue to seek "higher quality growth" rather than a more rapid change in consumer spending.

This may result in a "paradox of thrift". As households seek to protect themselves by securing their balance-sheet resources, the economy may collectively face insufficient demand causing government and bank debt burdens to rise disproportionately. This would, in turn, require even stronger and more costly stimulus measures later.

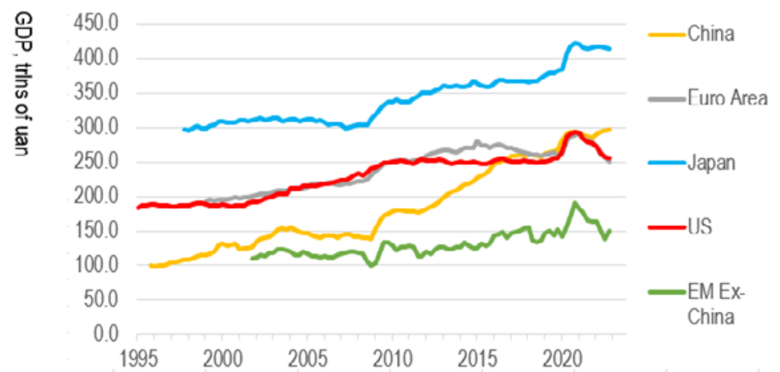
Servicing debt requires income generated by economic output (**Figures 10-11**). When an economy is overheating in an inflationary period, it can be helpful to "deleverage" to slow growth. But doing so in a period of already low inflation and high unemployment risks a self-reinforcing deflation (**Figure 12**).

Figure 10: China Nominal GDP and Domestic Debt



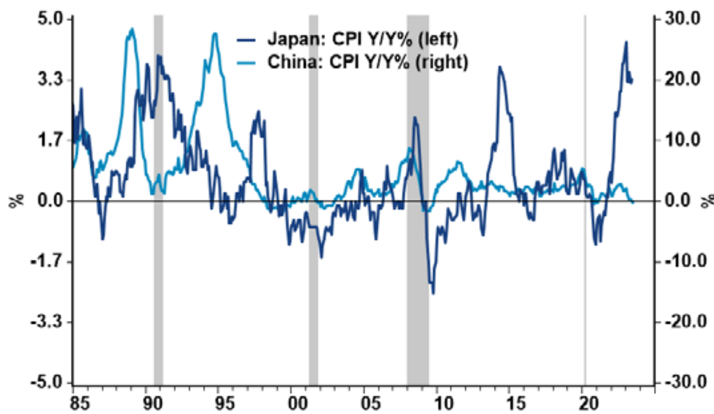
Source: Haver analytics through August 15, 2023. Shaded areas are recessions

Figure 11: Non-Financial Debt as % of GDP: China, EM-Ex-China, Euro Area, Japan, US



Source: BIS through August 15, 2023.

Figure 12: CPI Year over Year: China vs Japan



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China's Big Decisions

China will either stimulate broadly again as it did in 2008 and 2020, or fall behind in a way that is reminiscent of Japan from a macroeconomic policy perspective.

It is essential that China's policymakers contain the damage from its unfolding real estate crisis. A first order priority must be the ringfencing of the national real estate problem. For example, China may have to contain local government finances in the lower-tier cities to facilitate the restructuring developer debts. This would reduce systemic risk meaningfully.

The country will also have to drive demand for real estate. Residential property sales growth remained negative in 2022. With many projects unfinished, property buyers are reluctant to the take on risk despite substantial price cuts and supportive government policies like the 31-point plan released last month. To restore confidence, the government will need to provide capital access to allow the completion of specific projects over time. This will benefit employment and begin to restore demand as consumers see progress.

China has intervened to support its real estate markets before. Property policy support occurred during previous economic cycles: 2008-09, 2012-13 and 2015-16 when fiscal stimulus, monetary easing and credit expansion were all rolled out. While the current problem is systemic and materially larger, there is historical precedent for interventions and support.

A Domestic Consumption Boost

As suggested by the weak trade growth numbers in July (exports -14.5%y/y, imports -12.4%y/y), domestic demand is contracting at a fast-than-expected pace, while external demand for Chinese goods continues to fall.

As such, stimulating domestic investment and demand is necessary. While China may want to avoid fiscal weakening and repeating stimulus, an under-employed economy needs this. Central government fiscal support for provincial governments, infrastructure and real estate restructuring could amount to between 5%-10% of Chinese nominal GDP though 2024. The spending would boost hiring and consumption. While this seems large, it would be significantly less than US COVID-related spending in both 2020 and 2021.

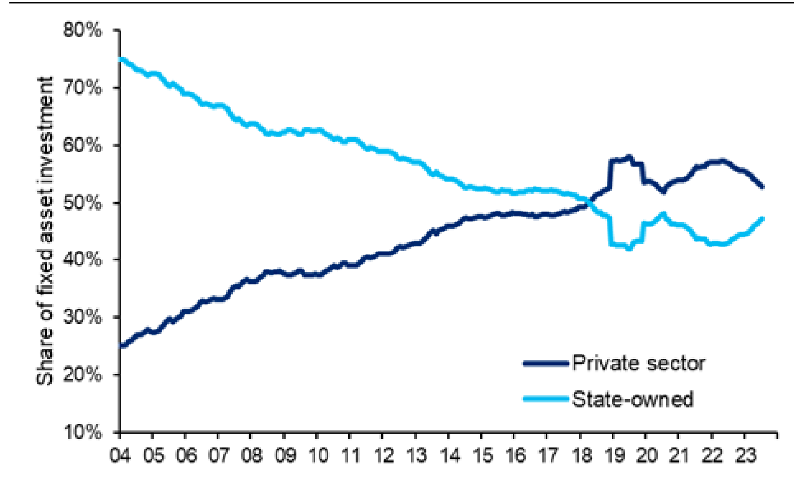
Finally, ending much of the regulatory clampdown, including constraints on platform tech companies, education and other sectors, would help restore business confidence. In recent months, policymakers and major government officials, including President Xi, have emphasized that reviving the private sector is one of top policy objectives. Bold actions need to follow the statements.

What Happens if China Does Not Respond Decisively?

China's consumer prices fell marginally over the past year. With producer prices falling 4.4% over the same period, industrial profits fell about 9%. These profits won't turn around until demand improves. Until such time, private investment in China will also weaken (**Figure 13**). If this is allowed to continue, the severe real estate credit weakness will broaden to healthier sectors and China's economy would stall at a lower equilibrium level.

Even though official pronouncements from China are showing increasing urgency, we have not seen a meaningful emphasis from top leadership on major reforms and stimulus.

Figure 13: Share of fixed asset investment – private sector



Source: Bloomberg, Haver Analytics, as of August 17, 2023

Disinflation in China May Benefit Western Markets

If China stays on its present course of slow and insufficient stimulative action, we would view consequent strength in the US dollar, weakness in Chinese demand and falling export prices to be a global disinflationary force.

Chinese export prices have already fallen 7% over the past year. Many have argued that the disinflationary impulse of Chinese exports on US consumer prices during the past two decades had already run its course. If China does not turn around, it would be another strong factor weighing against the popular view that the US is facing a higher long-term trend rate of inflation.

Impact on US Bond Markets

With US bond yields at 16-year highs, inflation diminishing and global demographics not dissimilar to China's, we believe the case for high grade US bonds is increasingly compelling (**Figure 14**).

Figure 14: US Treasury 5-year Note Yield (%)

Source: Haver analytics through August 18, 2023. Shaded areas are recessions.

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Bond rating equivalence

Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

Bond credit quality ratings	Rating agencies		
Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Ratings[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3 to show relative standing within the category.
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MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

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