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Global Emerging Markets

Understanding China's 'Stimulus' & The structural Challenges Facing the Country

In the report below we discuss the recent stimulus announced by China's government and why this does not change the fundamental economic drivers for the country nor the poor risk / return equation that its equities offer long term investors. We therefore see the recent stock market rally in China as unsustainable.

Chinese shares surged in the September quarter due to optimism around 'stimulus' measures that coincided with the 75th anniversary of the Chinese Communist Party (CCP). The Shanghai Composite Index, for example, surged some +29% between the 13th of September and the first week of October. Meanwhile Chinese industrial profits for the month of September collapsed -27% YoY, the worst performance so far this year, and the Chinese auto industry reported a -21% YoY decline in profit for the month. China's consumer price inflation (CPI) latest reading, at 0.4%, is suggestive of economic stagnation and near-deflation. So what really is going on, and was the dramatic rally in Chinese shares justified?

In order to understand what China's recent 'stimulus' represents – and perhaps even more importantly, what it doesn't represent – we need to briefly revisit Xi Jinping's accension to power. This will also help illuminate other signature Xi policies such as *Common Prosperity* and his relentless anti-corruption campaign.

Exhibit 1: Teenage Xi Jinping after being deported to Shaanxi to dig ditches (Source: The Guardian)

As a teenager during the Cultural Revolution, Xi's secondary education was cut short when "all secondary classes were halted for students to criticize and fight their teachers" (see end note for sources, unless otherwise specified). He was subsequently deported to the interior province of Shaanxi to work as a farmer and ditch-digger, where he was forced to live in a cave in the remote village of Liangjiahe. This was a significant hardship for Xi who had, until the Cultural Revolution, grown up as an elite in Beijing with a father who was Vice Chairman of the National People's Congress. At the age of fifteen (the same year that young Xi was banished to the countryside) he watched as his father was publicly denounced by his mother and imprisoned as an enemy of the Mao-led revolution. Xi's sister Heping had been murdered a few years before by student revolutionaries.

After a few months, unable to stand the appalling conditions he faced in Shaanxi, Xi attempted to escape to Beijing. He was immediately caught, arrested and sent to a work camp, but was later permitted to return the village. On return he worked as the party secretary for Liangjiahe.

Exhibit 2: Xi's Father publicly denounced during the Cultural Revolution (Source: The Guardian)

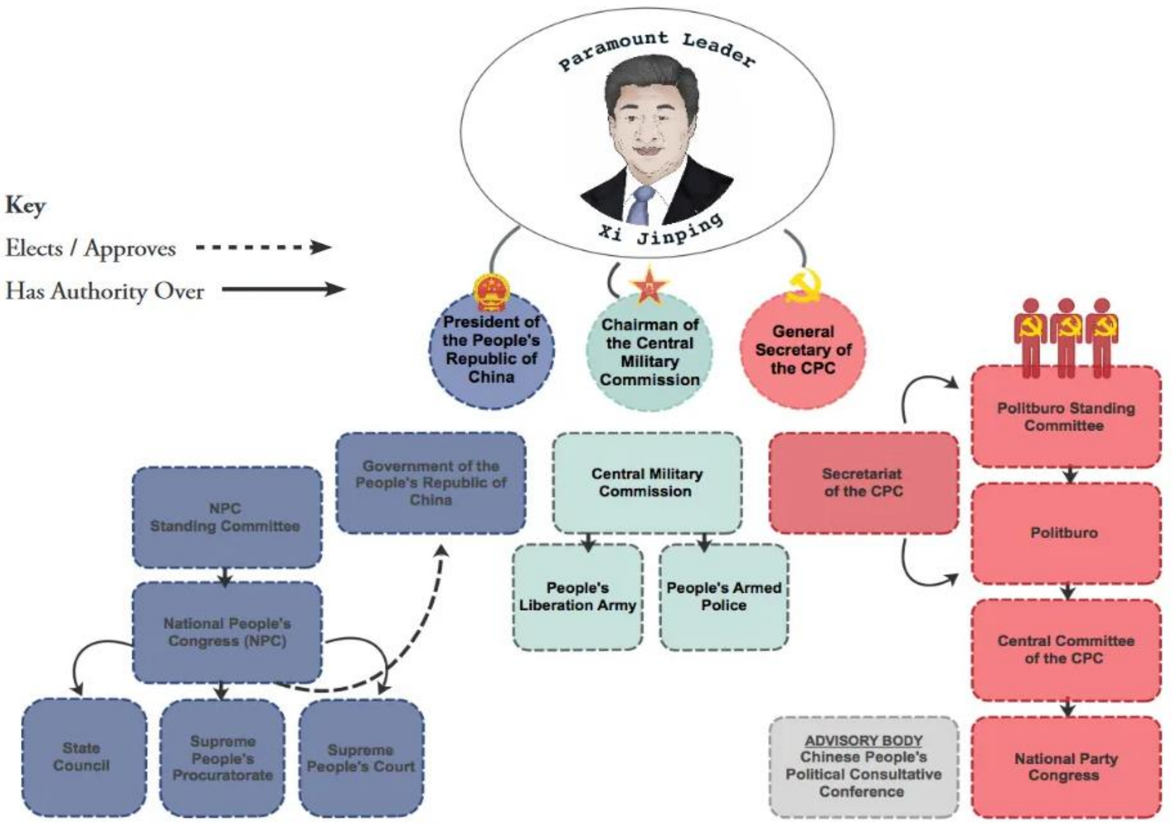
Xi's personal history in the Cultural Revolution was a significant reason for his selection as Paramount Leader (see Figure 3) when Hu Jintao retired. The thinking of China's CCP officials was that Xi's years of hard labor in central China made him more palatable to the China's vast working class than the average East Coast elite (who form the backbone of senior Communist Party officials) would be.

Although Xi's tough youth was originally viewed by CCP officials purely through a marketing lens, his years of hardship in Shaanxi appear to have profoundly affected his world view and personal philosophy. "The lesson that Xi had learned was that by being a good and obedient communist, you could survive and even thrive, even if that meant forgetting the party's treatment of his father," says Professor Michel Bonnin, an expert on the Cultural Revolution. Often considered an ideological fanatic, Xi earned a PhD in Marxist theory and political education from Tsinghua University whilst he governor of Fujian province. He developed a disdain of elites and experts, according to a former professor at the Communist Party School, Cai Xia. "Why, unlike his predecessors, is Xi so resistant to others' advice?" she wrote in a recent article for Foreign Affairs. "Part of the reason I suspect is that he suffers from an inferiority complex, knowing that he is poorly educated in comparison with other top CCP leaders."

Unlike his predecessor, whose policies of growing and integrating China's capital markets largely benefited the highly educated and wealthy coastal population, Xi's actions and speeches are indicative of a profoundly Maoist world view. As NPR notes, just as "Mao Zedong built China's Communist revolution on the back of the country's impoverished peasants…Xi Jinping wants a new…revolution to take root in the countryside". He has shown an open disdain for financial speculation, both in the property market ("houses are for living in, not for speculation") and in equity and debt markets through a heavy-handed approach which has included salary caps for finance workers (3 million RMB or roughly US$415,000) and a number of arrests of investment bankers. It has become common practice for finance industry workers to surrender their passports to local officials to prevent them leaving the country. These policies have severely damaged sentiment in the residential property market – historically the single most important driver of China's economy.

Other clumsy interventions such as the sudden cancellation of the Ant Group public offering in 2020, expected to be the biggest IPO in history, and the abrupt restriction on private education companies, which caused share price declines in excess of -70% for some US-listed Chinese companies in the sector, show a leader who fundamentally doesn't care about the stock market. Unlike the West, listed shares are not an important part of household wealth in China, particularly for the poorer inland population that is Xi's core focus. As GIS points out, the latest data shows that whilst 60% of household wealth is tied up in residential real estate, less than 5% is invested in stocks. This is a frequently misunderstood point because share *trading* in China is dominated by retail investors, but this largely reflects a minute portion of the population who engage in frenetic daytrading. Hence those long-term China bulls who are holding out for a Chinese stimulus specifically directed at improving share market valuations are fundamentally misguided.

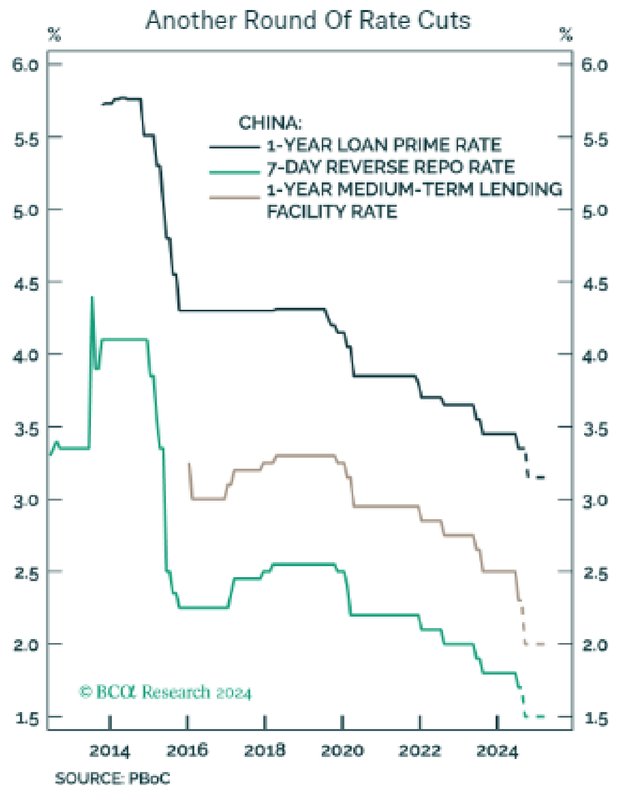
Exhibit 3: China's Leadership Structure Source: Institute for Security & Development Policy



It is unsurprising then that the share market portion of the stimulus measures announced in September is highly underwhelming. A total RMB 800m (US$113bn) in direct support for the stock market was announced, comprising RMB 500m in a swap facility to allow mutual funds and insurance companies to access liquidity to buy stocks and RMB 300m for banks to lend to listed companies for the purpose of share buy backs. In aggregate this is equivalent to just 1.6% of China onshore market cap. The financial support was bizarrely combined with a barrage of "upbeat short video posts on the outlook for the stock market" (SCMP) taking inspiration from the U.S. meme stock phenomenon to encourage domestic retail investors and amateur traders to buy Chinese stocks. In hindsight it looks very much as though China was simply trying to engineer a short-term rally in the local share market. The rational was likely the 75th anniversary of the founding of the CCP on October 1st, particularly as we have seen evidence of other artificial stock market rallies coinciding with other important CCP milestones.

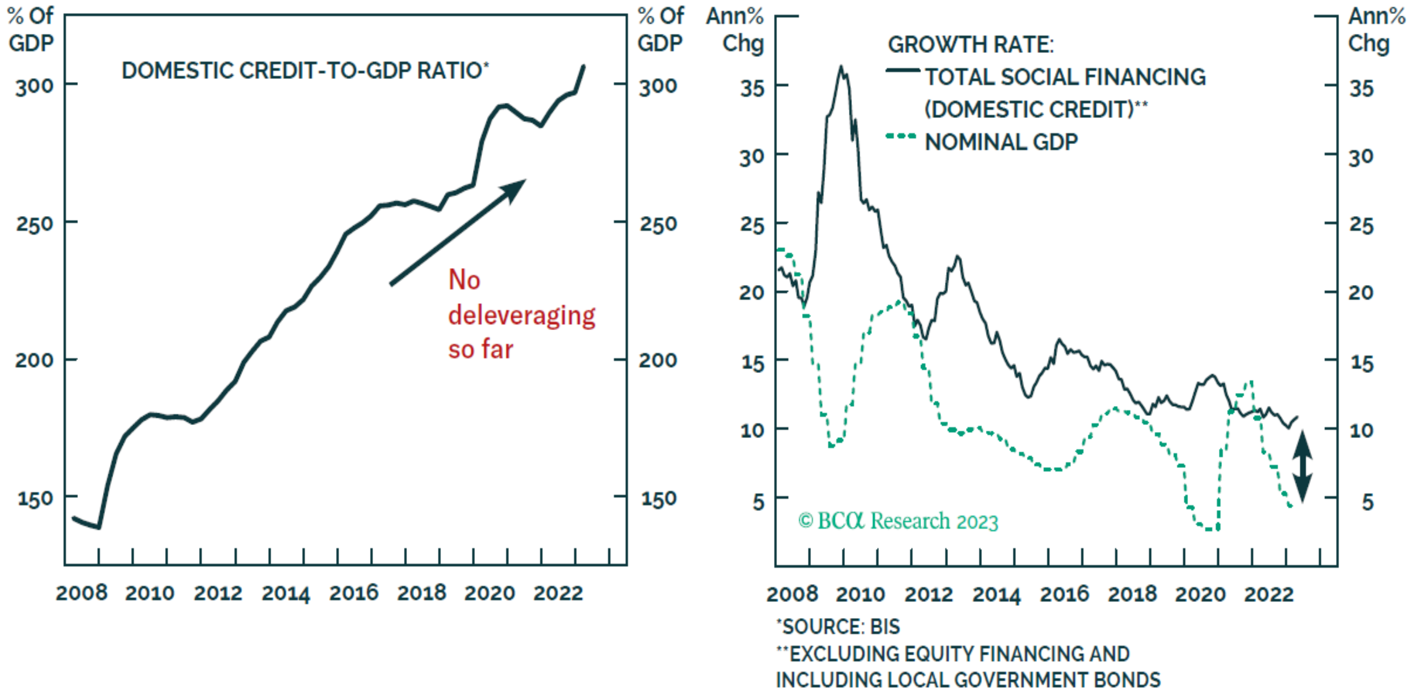
The other elements of the 'stimulus' are also underwhelming. In fact most of the measures announced are indirect and were already expected. Unlike previous economic stimulus, there was no major fiscal measures announced, with monetary policy the focus instead. The monetary measures announced included cutting the Reserve Requirement Ratio (RRR) for banks by 50bps – a move which was already widely anticipated – and cutting the 7-day reverse repo rate by 20bps (see Figure 4).

Exhibit 4: Most of the 'stimulus' was simply modest rate cuts (Source: BCA)



Beijing also directed banks to cut the headline residential mortgage rate by 50bps and reduce the minimum down-payment on second homes from 25% of value to 15%, small measures unlikely to result in a material improvement in China's struggling property market. Finally there was 2 trillion RMB of new bonds issued to help local government balance sheets (which are in weak shape since the main source of revenue for local governments in China is land sales that is highly dependent on property market sentiment) and a combined 1 billion capital injection for SOE banks. Altogether the measures announced were equivalent to less than 3% of GDP, a far cry from the 2008 stimulus which was more than 12% of GDP.

Exhibit 5: More Debt, Lower Growth in China (Source BCA)

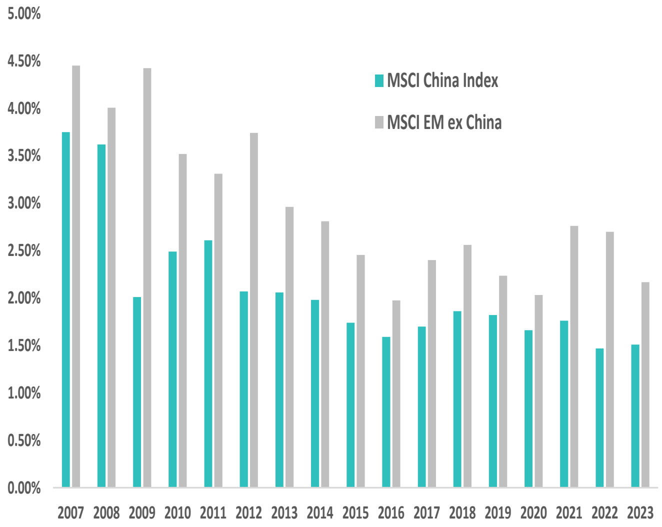


Beyond the stimulus, the Chinese economy faces a number of important structural challenges. First, demographic change has become a significant headwind for the country. The country's fertility rate (1.09) has dropped well below even that of Japan (1.374) and some projections have China's population falling by half by the end of the century, a population implosion the likes of which the world has not seen since the bubonic plague.

Against a backdrop of a population which is already in decline, debt continues to increase rapidly. Meanwhile the productivity of debt continues to decline, as shown in Figure 5. This is a consequence of continued misallocation of capital, as evident in Chinese companies' structurally lower returns on capital than other emerging market companies (Figure 6).

The latter is particularly important for equity investors, since in the long term there is a direct relationship between return on capital earned in a country and the performance of its share market. China's unique economic model means that capital allocation decisions made by the private sector are significantly influenced by goals other than simply maximising shareholder value, including provincial investment and employment targets, and other national strategic goals. The return on capital generated by Chinese companies has consistently been lower than Emerging Markets peers. As such, unless there is a significant change in the Chinese economic system, Chinese shares should continue to underperform the broader EM benchmark over the long run.

Exhibit 6: Chinese Companies Earn Structurally Lower Returns (Bloomberg data



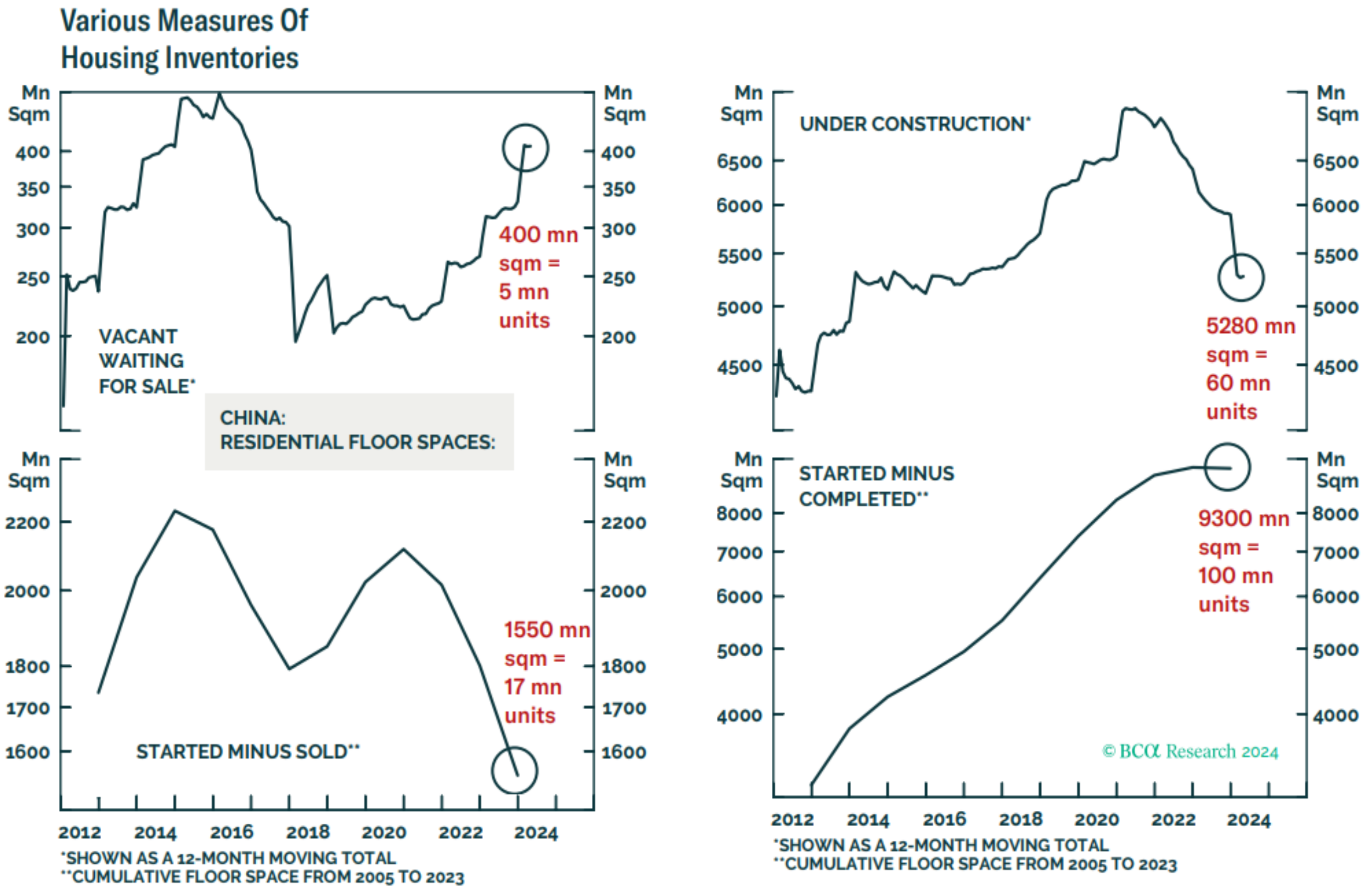
Since Beijing will use every tool it has to avoid a full-blown financial crisis, assisted significantly by China's closed capital account, the most likely outcome of China's spectacular accumulation of debt is economic stagnation as the productivity of incremental investment continues to decline. Further, whilst some pundits argue the contrary, the Chinese consumer will not bail out the economy. In addition to a shrinking population, China's households are heavily indebted relative to earnings, with a household debt to income ratio similar to the US but at a much lower level of GDP per capita. This means that there is limited room for household consumption to become the new engine of China's economic growth.

Perhaps the biggest popular misconception about China's economic growth over the past two decades is that it has been an "export led miracle" in the vein of the Asian tiger economies. Instead, it is more accurate to think of the country's golden period of growth as a massive property boom. World Bank data shows that total exports of goods and services in China is just 19.7% of GDP. By comparison, this figure for the UK – not exactly an export powerhouse – is 32.7% and when we look at countries traditionally thought of as exporters such as Germany (50.3% of GDP) and South Korea (88%) the contribution from exports is far higher.

Instead the fundamental driver of the Chinese economy has been Fixed Asset Investment (FAI) and particularly residential property investment. In the US (which, unlike China, has growing demand for dwellings due to a combination of robust population growth and a decline in the number of individuals per household) the residential property market's combined contribution to GDP generally averages 15 percent, according to the National Association of Home Builders. By contrast, residential property investment in China has averaged around 25 percent of GDP and was as much as 29 percent during the boom years.

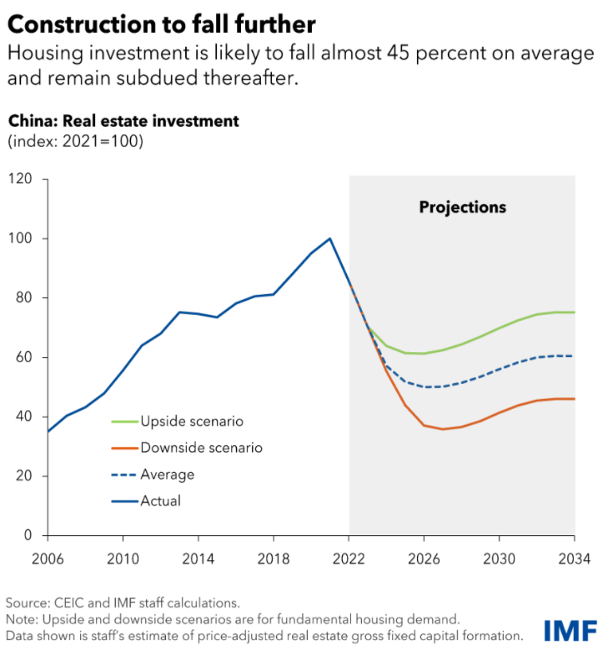
China has struggled to shift to an alternative economic model, even as population peaked and started to decline, resulting in a substantial overbuild. There are several ways to measure housing inventory but, as Figure 7 shows, whichever metric one looks at shows China is sitting on a massive overbuild. The broadest gauge – housing starts less completions – suggests China may have an inventory of as 100 million units. This is in addition to at least 80 million vacant apartments, according to He Keng, a former deputy head of the National Bureau of Statistics in the country. All this in a country where the population is declining.

Exhibit 7: Various Measures of Property Inventory (source: BCA Research)



Earlier this year, the IMF projected that residential property investment in China is likely to fall -45% and never recover to the levels seen over the past decade (Figure 8). This implies, *ceteris paribus*, a 10%+ downward adjustment to the country's GDP with no foreseeable bounce back. This is even before the likely second order effects such as loss of confidence and declines in industries leveraged to the property market.

Exhibit 8: IMF Projections for China Residential Property Investment (February 2024)



Ultimately China's leadership faces an unenviable choice. If the priority is stemming a decline in property prices – a key goal given the importance of real estate to household balance sheets in the country – then policy must result in a massive decline in property investment, given the current supply-demand imbalance. As the IMF points out, this would leave a significant hole in China's economy which would take many years to recover from. The alternative would be to encourage continued investment in residential property construction, which would help support economic growth but would inevitably lead to property price declines given there is already a substantial overbuild, destroying household wealth. Given the second approach could well lead to social unrest, we expect the leadership will focus on stemming property price declines at the expense of economic activity.

In summary, investors should look past the modest 'stimulus' measures that we saw in September and will likely see again, and instead focus on the enormous structural challenges facing the Chinese economy and local share market.

The section on Xi Jinping was informed by both Elizabeth Economy's book, "The Third Revolution' and particularly Scott Alexander's review of that book, which significantly expanded on the original's commentary. We also thank BCA Research for permission to use their charts.

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