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CIO Viewpoint

China's rising wealth drives shift in growth ambitions

Investment Solutions

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As China gets richer, it is switching economic focus from generating wealth to securing higher-quality industrial self-sufficiency. To reflect this change in focus, China introduced more flexibility into its growth target. In the short term, as the first country into and out of the Covid pandemic, it is now the fastest to normalise fiscal and monetary policy. That has implications for holders of Chinese assets.

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Key takeaways

- China's latest five-year economic plan introduces more flexibility to its growth targets
- The country may see its GDP expand 9% this year, and focuses on economic quality as average incomes rise
- First to recover from the pandemic, China is the first to normalise policy support
- Short term, we have cut Chinese equity exposure to reflect slowing market momentum.

At the National People's Congress earlier this month, the government set a loose target of more than 6% growth for 2021. For the first time, the NPC did not lay out an average GDP for its new Five-Year Plan. Historically, the plans set out strict production quotas borrowing from the Soviet Union's economic model. Since 1953, the plans have served as a communication tool from Beijing's central government to the regions. The Covid pandemic meant that China missed its 2015-20 annual GDP target of 6.5%.

"We will keep major economic indicators within an appropriate range, set annual targets for economic growth in light of actual conditions," said Premier Li Keqiang at this year's NPC. "Doing so will enable us to achieve higher-quality development that is more efficient, equitable, sustainable and secure."

China recorded economic growth of 2.3% in 2020, its lowest rate since 1976 but still higher than any other major country. A year ago, the NPC did not fix an annual target, since the pandemic made the economic outlook too uncertain.

Although 2020's annual growth fell short of the previous five-year target, growth in the fourth quarter of last year was strong and even taking account of tightening measures, we expect GDP to expand 9% for 2021. China also plans to cut its deficit from more than 3.6% last year to 3.2% in 2021. Some strategic sectors, such as technological research and development and the military budget, are excluded from cuts. We expect the People's Bank of China (PBoC) to begin raising interest rates by 30 basis points, over three steps starting towards the end of this year. This would impact growth next year, we believe, trimming GDP expansion to around 5%.

In contrast, the US Federal Reserve upgraded its growth outlook for the American economy last week while underlining that it does not foresee raising interest rates before the end of 2023. China's 10-year government bond yield stands at 3.26%, compared with 1.67% for 10-year US Treasuries as we publish.

Cost of credit

China's growth comes at some cost. Credit in the Chinese economy may have peaked as the government tries to balance financial risk in the economy and reduce debt. The PBoC has already removed some liquidity from China's financial system, as it wants to avoid asset bubbles in sectors such as real estate. As a result, the country is letting firms including state-owned enterprises (SOEs) default on their debts, reforming bankruptcy rules and restructuring inefficient companies while prioritising employment. One fifth of the USD 10 billion recorded in Chinese corporate defaults this year are property developers.

Fitch rating agency grades China 'A+' with a 'stable' outlook. It pointed this month to the process of tapering credit, which, the agency said, "could pose downside risks to the rating."

China has also started applying more regulatory oversight to technology firms, including fair competition rules. This month, the state market regulator said that it fined 12 companies for anti-monopoly violations including Tencent, Baidu and SoftBank.

China is on track to achieve its ambition of becoming a high-income economy and double the nation's gross domestic product over the next 15 years. The World Bank considers an economy 'high income' with per capita gross national income (GNI) of more than USD 12,535. China recorded a GNI of USD 10,410 per person in 2019, a ten-fold rise since 2001. At current rates of growth, the country is on track to achieve the 'high income' threshold within five years. However, the Chinese administration will also need to reduce inequalities as an estimated 373 million people in China still earn less than USD 5.50 a day.

Strategic collision

Nevertheless, China's path of economic recovery and expansion puts it on a collision course with the US. In December 2020, the US banned exports of semiconductors to China, the world's biggest importer of the chips. Given just how critical these components are to any industrial ambition, China is trying to accelerate its domestic industry to become self-sufficient. The Chinese government has directed subsidies to the industry and added more than 10% to its research budget to support the expansion of 5G and fibre optic telecommunication networks.

When China joined the World Trade Organisation in 2001, the expectation was that over time, the centrally planned economy would increasingly align with the Western liberal democracies. Instead, the world is looking more polarised. China is increasingly assertive as it gains economic influence in the world. Since 2009, its share of global GDP has risen from 13% to more than 17% and many economies have become dependent on its business.

After the trade tensions between the US and China in recent years, there were expectations that the tone of dialogue with the US under the Biden administration would calm. There was little evidence of that happening last week. On 18 March, opening statements to reporters ahead of US/China talks in Anchorage, Alaska, deteriorated as each delegation broke with diplomatic protocols to offer some frank opinions on one another's policies. Given the context, the statements look aimed at their own domestic audiences. A few days earlier, the UK published a strategic paper that includes an assessment of China, warning of the "systemic challenge that it poses to our security, prosperity and values."

Military spending is not part of China's cost cutting programme. The defence budget is expected to rise by 6.8% to 1.355 trillion yuan, which follows an increase of 6.6% in 2020.

The positive thing at least is that some of the most contentious differences between China and the West remain compartmentalised and slow burning. These include the treatment of Uighur people in Xinjiang, questions of strategic technologies including Huawei, import tariffs, Taiwan's status and support for North Korea.

Managing exposures to Chinese assets

When looking at investments in Chinese assets, we need to differentiate between the short and long term. Our case for a strategic allocation to Chinese assets remains intact over time. However, shorter term, last year's growth momentum has faded. The country is the most advanced along the path to recovery, and so it is among the first to normalise monetary and fiscal policies. Furthermore, the MSCI China equity index is less exposed to cyclical sectors poised to benefit from this changing environment.

We have reduced our exposure to Chinese equities to reflect this as we see better opportunities in global small capitalisations. We keep our exposure to Chinese government debt given the broad spread to US Treasuries, and low correlation to rising US yields.

The Chinese currency, where our exposure is overweight, has remained remarkably stable throughout this period. China's strong balance of payments and higher yields should support the renminbi, and we expect the currency to outperform the dollar, euro and Swiss franc.

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