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CIO Viewpoint

Assessing China's outlook in a crucial year for Beijing

Investment Solutions

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Amid geopolitical conflict, market turmoil, Covid outbreaks and a domestic real estate crisis, China faces tough decisions in a crucial election year. While the risks are high in some Chinese assets over the short and medium term, we believe others continue to offer value, diversification and decent yields.

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This year, stability is a political imperative for China. At the five-yearly Party Congress, scheduled for October/November 2022, President Xi Jinping is expected to seek a third term in office, rewriting Communist rules in a way that only Mao Zedong and Deng Xiaoping have managed in the party's 100-year history. Yet in such a crucial domestic political year, China has to balance relations with Russia and the West over the Ukraine war, a related commodity price shock, the Omicron wave and market volatility exacerbated by poor credit data and the ongoing property fallout.

China's biggest immediate challenge is Covid-19's Omicron variant. Previously, the government's handling of the pandemic had been a symbol of national pride. Now the 'zero tolerance' strategy is under strain. Shanghai, China's financial centre, has entered a nine-day lockdown, even as measures are lifting in Shenzhen. So far, the economic impact seems manageable. In some factories, workers have remained in bubbles, sleeping on site overnight to keep production going. In some cases, high-tech manufacturing can be shifted elsewhere. However, economic output will inevitably suffer and any closure to Shenzhen's port – one of the world's busiest – would be a blow to gross domestic product and global supply chains.

While China is targeting 5.5% growth for 2022, we believe 4.7% is more likely, allowing for a likely contraction in the first quarter and a sizeable hit in the first half. Such risks are hard to model however, and the pandemic's impact on growth may yet be larger.

Real estate concerns persist

A second worry is real estate and credit issues, in an economy that is heavily dependent on both. Data for February was particularly bad: new medium-to-long-term credit extended to households – a proxy for mortgage lending – was negative for the first time on record. New home prices fell for a sixth straight month. The value of housing sold in January and February fell 22% year-on-year. Such concerns combined with regulatory worries over US-listed Chinese firms – amid a row with

Key takeaways

- China faces challenges: Covid lockdowns, a property crisis, a commodity price shock and a geopolitical balancing act. Economic and financial stability are key in a crucial political year
- We expect 4.7% growth for 2022, some way below the authorities' 5.5% target
- A continued neutral stance on Russia would benefit China's economy. Secondary sanctions could damage Chinese firms
- We retain an overweight in RMB-denominated government debt for its yield and diversification properties. We remain cautious on Chinese credit and neutral on equities, and maintain our USDRMB 6.35 forecast for the first half.

the Securities and Exchange Commission over access to audit documents – to spark sharp market falls on 14 March.

The big question is whether China's policy and regulatory response will be enough to shore up the economy and risk assets. On 16 March, Vice Premier Liu He vowed to "actively introduce policies that benefit markets" and "boost the economy", mentioning both the technology and property sectors and sending stocks up again. China now looks prepared to make some audit information available to US authorities, which could help lift an overhang for around USD 2 trn of foreign-listed shares.

We expect aggressive monetary and fiscal easing in the first half, including a total of 20bps cuts to the main lending rate, and a 50 bps cut to banks' reserve ratio requirements. Going forward, the central bank might need to rely on more targeted policy instruments, such as its medium-term lending facility and loans to specific sectors. Spending to support pandemic-hit industries, infrastructure, manufacturing and R&D is rising, with tax cuts for small and medium-sized enterprises (SMEs), and income tax relief for bonuses and stock options. Yet on property and credit, the picture is less clear. Leverage restrictions imposed on developers in 2020 – the 'three red lines' – remain in place, albeit with some curbs on loans relaxed. This seems contrary to Beijing's wider macroeconomic ambitions. We believe there could be scope for manoeuvre here, yet for now, it is too early to say if China's policy measures can offset risks, particularly in property and credit.

Under pressure on Ukraine

China's role in the Ukraine conflict is top of Western minds. President Putin's invasion came less than a month after he and President Xi declared a "friendship without limits." Yet the Ukraine attack appears to have wrong-footed Beijing. Mr Xi has since sought to tread a delicate path between concern about the harm to civilians and supporting an ally in his fight against US hegemony: urging restraint from Russia, while also blaming NATO's expansion. The situation could easily escalate. Sending economic or military support to Russia could put China on the wrong side of Western sanctions, and a humanitarian disaster and energy shock could spiral into retaliatory measures and a global economic war of attrition.

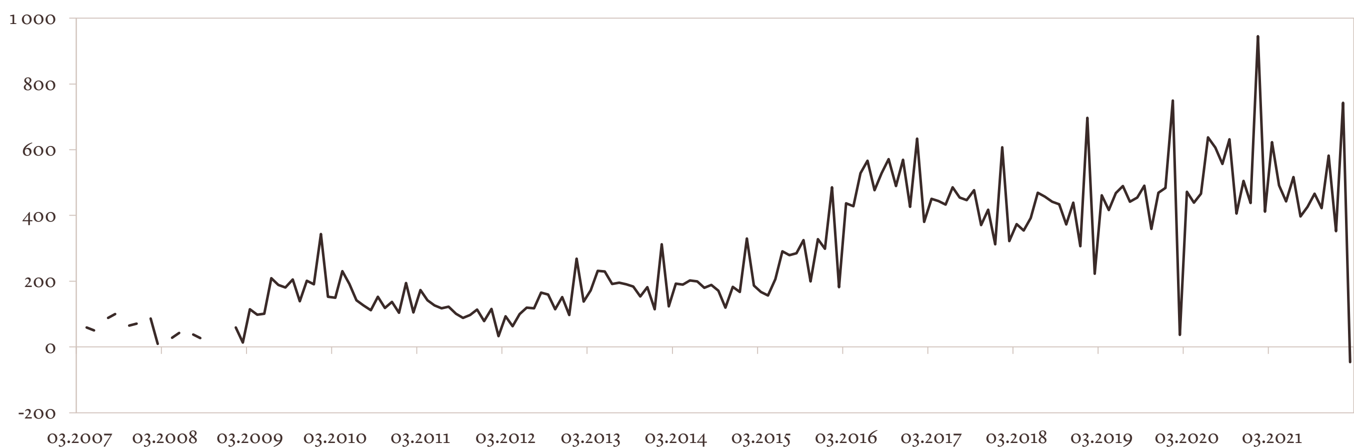
For now, we believe this looks unlikely. A continued neutral stance on Russia would benefit China's economy – setting aside the commodity price shock it and all energy importers are suffering. Conversely, a clear pro-Russian positioning would damage growth, investment flows and China's share in global trade. Outside oil, gas and some weapons trade, Russia's importance for China is small – just 2% of total exports – while its economic ties with the US (17.5% of exports), Europe (more than 7%), and Western-leaning neighbours such as Japan (5.5%), South Korea (4%), and Singapore (2%) are vast.

China has a huge stake in global economic stability, and has thrived in the rules-based order; exports to the West have helped lift millions out of poverty. It also has economic interests in Ukrainian companies and infrastructure. A weakened Russia might even help China longer-term, via cheap energy supplies, and better access to Russian ports or natural resources in the Arctic. In the medium term, it could also be in China's interest to pursue mediation with Russia, while the opposition seen in Ukraine may stay its hand from any precipitous use of force in Taiwan.

Still, the threat of 'secondary' sanctions on Chinese companies that deal with sanctioned Russian entities remains, even if China and India are outside an export control regime that is emerging as a pressure point for President Putin. Secondary sanctions pose particular risks for Chinese banks, transport

1. A bad month for credit

New medium and long-term loans to Chinese households, RMB bn



Sources: People's Bank of China, Bloomberg

firms, those dealing with Russian energy suppliers, and tech companies supplying components to Russia. Ultimately, we believe most large Chinese firms will comply with Western sanctions, to retain access to global capital markets and avoid disruptions to sales elsewhere. But trade with Russia could continue via smaller Chinese and Indian firms, and via transactions settled in renminbi.

Assessing our positions in Chinese assets

Our overweight position in renminbi (RMB)-denominated government debt has proved a valuable source of returns. Chinese bonds have been fairly immune to the significant repricing in US and EU government bonds. While the yield differential has narrowed as a result and there is less scope for further currency appreciation, we remain comfortable with the position from a portfolio perspective. Bond prices should rise as China cuts rates, while the real interest spread with US Treasuries remains positive given high US inflation. Crucially, Chinese government debt still acts as a portfolio diversifier, thanks to its low correlation with other assets. With credit growth disappointing recently, we remain cautious on Chinese credit. Both investment grade and high yield segments look attractive from a valuation perspective but it is unclear at this point what will stem the recent outflows and negative price momentum.

We are also neutral on Chinese equities. The asset class certainly looks cheap versus history. US listed Chinese firms are trading around 15 times earnings, versus 30-40 times in much of the last two years. At 10x forward earnings, the broader MSCI China Index is trading at twice its historical discount versus the MSCI World. But the risks look high. Chinese retail investors could be wary of buying stocks when their main store of value – property – is in such a weak position. Efforts by authorities to support equities in 2015 saw a big market run-up and subsequent fall, after debt rules were tightened. Investors worry the same could happen again after the crucial Party Congress. The economy requires ongoing policy and regulatory support – yet the 2021 crackdown on technology firms was severe. Many US-listed Chinese companies may now prefer the greater certainty of Hong Kong listings. China's geopolitical role also remains a big unknown, weighing on the appeal of local stocks to foreign investors.

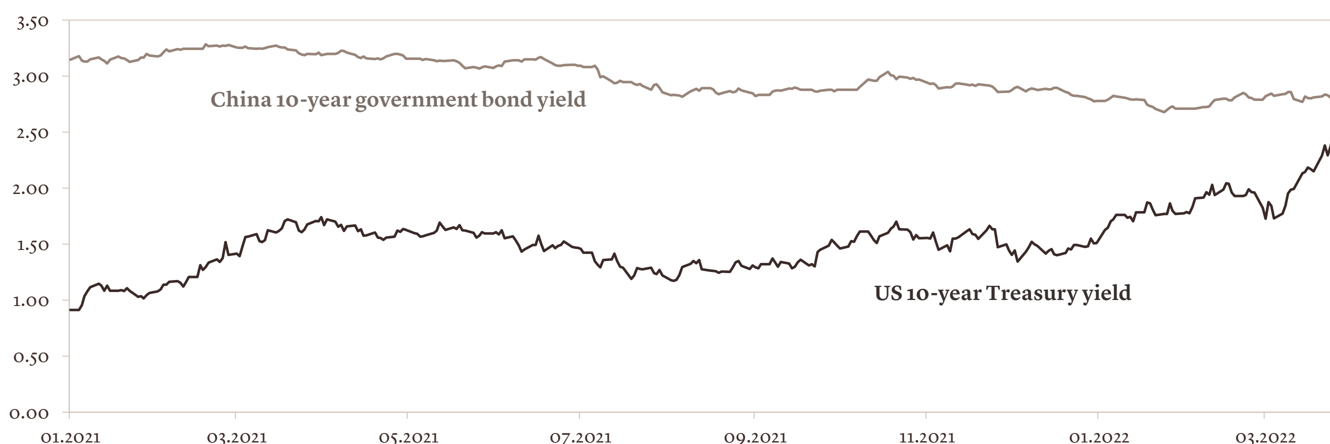
We see two opposing forces acting on the currency in 2022: policy easing from the People's Bank of China reducing the appeal for investors, and strong external balances bolstering it. We assume the latter will dominate, helped by ongoing Covid restrictions that will deter outbound tourism. Accordingly, we maintain our assumption of USDRMB at 6.35 over the first half. That said, we will be monitoring risks related to any closure to ports which could pose risks to the country's stellar goods trade balance, a key source of support for the currency over the past eighteen months.

A deglobalising world; a transitioning economy

Beyond the immediate investment outlook, the Chinese economy also faces several longer-term challenges. The conflict in Ukraine is accelerating onshoring and deglobalisation that began with the great financial crisis, Brexit and Donald Trump's trade tariffs, and accelerated during the pandemic. This all weighs on global and Chinese growth. Meanwhile, China's shift from a production centre to a middle-income, consumption-driven economy remains challenging as the population ages. China's leaders have shown a strong command of the economy in recent years; a crucial political year will be just the start of further tests ahead.

2. Narrowing differential, but still yield pick-up

Difference between US and Chinese 10-year government yields



Source: Bloomberg

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