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CIO Viewpoint

China's Great Reopening

Investment Solutions

5 December 2022

China will reopen in 2023. The latest street protests will likely quicken the pace of the country's loosening of Covid restrictions. While economic reopening will be volatile, monetary and fiscal stimulus will support growth until activity can recover in the second half of 2023, and into 2024.

Prolonging China's strict 'zero Covid' restrictions is no longer politically tenable. Street protests on 24 November clearly demonstrated public impatience with the constraints. In a fire at an apartment block in the city of Urumqi, sealed doors - part of the city's quarantine protocols - prevented victims' escape. The outrage that followed has reached Beijing and Shanghai, and in some cases demonstrators held up blank sheets of paper to express their opposition to the government, even overtly calling for an outright change in leadership.

Most worrying for the country's leadership is that frustration and anger at Covid restrictions appears widespread, cutting across society, from students and workers to migrants and pensioners. How these protests evolve remains unclear, but we expect that open challenges to the Chinese Communist Party's rule will not be ignored. The authorities appear to be moving towards accelerating the reopening timetable. Many cities in Guangdong, one of China's largest and wealthiest provinces and a neighbour to Hong Kong, have announced further easing of Covid restrictions, despite spiking infections. Vice Premier Sun Chunlan, a public face of China's stringent controls since the start of the pandemic, told health experts on 30 November that the less-deadly Omicron variant, more vaccinations and better health management will let the country enter a new phase in its fight against the virus. Ms. Sun did not mention "zero Covid" in her speech and called for more shots for the elderly. Combined with reports of more tweaks to protocols on mass testing and home quarantine, China's leadership looks determined to reopen in 2023.

Metropolitan roll-out

That journey will see setbacks. Just 68% of China's population over the age of 60 has been vaccinated with three doses of locally-developed vaccines, which are less efficient than those developed in the West (see chart 1). The need becomes more urgent as we approach the northern hemisphere's flu season. Even though booster-shot campaigns are intensifying, the delays in rolling out vaccines will weigh on growth as authorities and consumers adjust to higher infection rates.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- China's reopening will accelerate as the country addresses social discontent with looser Covid measures
- Greater immunity through vaccinations in China's population, crucially among the elderly, is a priority
- We see a relatively conservative 4% GDP growth in 2023. Authorities continue their fiscal and monetary support, and we expect additional measures equivalent to 3% of GDP for 2023
- We believe that portfolios should stay exposed to Chinese assets as the country reopens. We retain our overweight position in Chinese equities and USD-hedged Chinese sovereign bonds while remaining underweight in the yuan.

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For this reason, our expectations for China's real gross domestic product growth are conservative. GDP should expand by 2.5% in 2022 and growth then pick up in the second half of 2023 to reach 4% over the full year. As the government looks set to remove many testing, tracing, and isolation protocols, we can expect an initial dip in activity. Many of China's neighbouring economies saw private consumption contract in the early stages of reopening as infections spiked. China's experience may be even more dramatic as its population's immunity levels are probably lower. But once the reopening has taken hold, growth should accelerate.

China faces the need to build immunity in its population of 1.4 billion after three years of low infections and slow vaccinations. The country has recorded fewer than 10 million cases and 30,388 deaths, according to [World Health Organization data](). The greatest dangers to the country's reopening process are either another nationwide lockdown to limit pressure on the healthcare system, or spikes in Covid deaths that exacerbate the population's fears. In our view, Guangdong province's loosening measures, and recent government statements, suggest China's leadership will try to avoid both extremes by letting large city areas with better healthcare systems reopen faster.

Looking beyond 2023

Reopening will be volatile and require more aggressive macroeconomic support before the outlook for the second half of 2023 and 2024 improves. The monetary and regulatory changes that we expected ahead of October's Party Congress are already intensifying. The People's Bank of China continues its monetary policy easing, including an additional cut to its reserve requirement ratio, effective 5 December, to increase liquidity in the commercial banking system, and the use of pledged supplementary lending (see chart 2).

China's fiscal policy remains accommodative as well. Authorities have implemented local government business and value-added tax refunds, a range of fee reductions from electricity to telecoms, and infrastructure spending. This equates to around 3% of GDP in 2022. Given the pressures on the economy, we expect support worth as much as another 3% of GDP in 2023, with strong stimulus over the next six months.

The government's real estate stance is also shifting. Regulators are letting property developers tap onshore capital after years of restrictions. The new framework facilitates bank loans, bond issuance, and equity financing for better-managed developers. This should ease solvency fears for these developers and allay homebuyers' anxieties about the delivery of pre-sold homes. Housing demand should then mend as the government has already eased mortgage rates and down payment requirements. As a result, we see real estate's strain on the economy weakening in 2023.

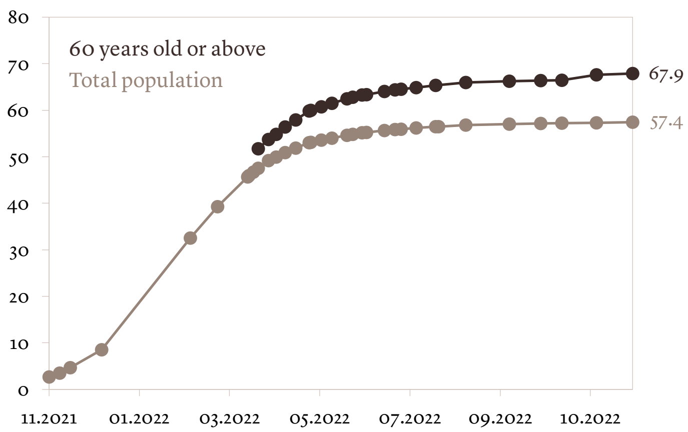
Still uncorrelated, still potential

The Chinese economy's challenges of weak Covid-related growth and property market woes are well known. Since May 2022, we have maintained an overweight position in Chinese equities. These initially performed well, before suffering a decline between July and October. Attractive valuations offer potential for a strong rally and recent stronger performance has improved our confidence in the outlook for Chinese equities. In addition, the market continues to show little correlation to other global equities. For now, we also keep our overweight position in Chinese sovereign bonds, hedged into US dollars.

Year to date, the dollar has gained almost 9% against the yuan. While the Chinese currency may see some support in the near term from a weaker US dollar, potential equity inflows would be more than offset by the country's worsening balance of payments. China's goods trade surplus and narrow deficit in services, built thanks to its zero-Covid strategy, will reverse as the economy reopens. Our portfolios retain their underweight exposure to the Chinese currency.

1. China needs to ramp up vaccinations for the elderly as quickly as possible

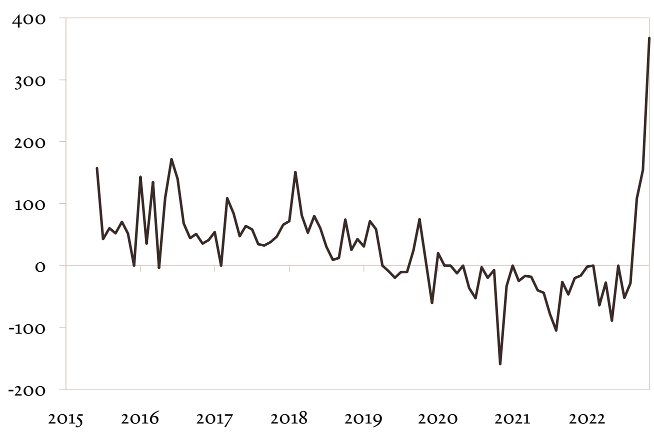
Booster shots administered as % of population, by age group



Source: CEIC, Lombard Odier

2. PBoC is supporting growth amid reopening signals

Pledged supplementary lending (PSL), bn yuan (a higher figure means more liquidity injections)



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