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# CIO Office Viewpoint

# Taking stock of China's reopening, and prospects

Investment Solutions

**22 May 2023**

**China has enjoyed an economic boost in 2023 after Covid restrictions were lifted. Monetary policy remains accommodative and while offshore share price gains have fallen short of investor hopes, onshore gains look robust. However, the country appears locked into strategic rivalry with the West, where tensions remain high. We look beyond the post-pandemic rebound to the prospects for the economy, and its financial assets.**

Investor sentiment on China remains fragile as they look beyond the positive impact of the country's reopening process. Compared with a year ago when some lockdowns were in place, the economy has rebounded. However, on a monthly basis, there are signs of slowing momentum. The total value of retail sales rose more than 18% in April compared with a year earlier, but the pace of monthly gains moderated to 0.5% compared with March. This dynamic was also echoed in the official data on industrial output or fixed asset investments.

We expect domestic consumption to serve as an anchor for China's growth in the remainder of 2023. Many high-frequency indicators for consumption remained strong in May, and point to positive momentum in the middle of the second quarter of 2023. While household and government expenditures account for just above half of GDP, their double-digit growth should more than offset softness in exports and capital expenditure. For this reason, we continue to look for a full-year real GDP growth around 5.5%, compared with 3% in 2022. For industries, the general trend to slackening regulatory crackdowns on targeted industries, including real estate developers, may add to positive growth catalysts.

The external picture has been more challenging. China's goods exports may slow by as much as 9% in US dollar terms this year as the West's decelerating economies reduce demand for Chinese merchandise, narrowing the country's current account balance to around 1-to-1.5% of GDP. This highlights the need for robust domestic demand. Rather than a recovery in trade in the near term, the weight of restrictive interest rates in the US and Europe is likely to further slow demand.

Policy support will be crucial to safeguard domestic demand. On the fiscal front, we see limited scope for additional cuts to taxes and fees imposed on businesses, without eliminating long-standing concerns around local government finances. Yet there is room for further monetary policy support if needed. The People's Bank of China (PBoC) appears ready to maintain its accommodative stance with onshore interest rates on hold for 2023. It may choose to further loosen the reserve requirement ratio, or RRR, a mechanism for freeing up liquidity in commercial banks. For the real estate sector, a more active easing of regulation might be needed to boost home buying and developer activities in addition to standard monetary policy tweaks.

### Key takeaways

- Following a strong first-quarter rebound, China's manufacturing, real estate and credit activities show signs of moderating. We expect domestic consumption to drive growth and see the economy expanding by 5.5% in 2023
- This mixed short-term picture should be offset by the PBoC's accommodative monetary policy, which we expect to remain in place into 2024
- Geopolitical fragmentation is visible in tensions over semi-conductors, Taiwan and Ukraine. US/China export controls will proliferate; China has already built a lead in electric batteries
- Chinese financial assets still offer diversification benefits. We see double-digit earnings growth in 2023 as stocks benefit from macroeconomic policies. In bonds, we find better alternatives to Chinese sovereign debt and see further yuan weakness.

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Markets will start to shift focus to longer-term economic prospects. Over the next five years we believe that China will average 4% real GDP growth as a decline in the working age population offsets steady expansion in productivity, and aggressive investments into frontier technologies. In the longer term, an aging population means that the economy will start to grow at a more stable pace, perhaps more comparable to developed markets, bringing a new set of challenges for China's policymakers, even though there is some scope to counter this headwind with even higher urbanisation rates and social reforms. Whether China can maintain its current manufacturing dominance in the age of friend-shoring remains an open question. It would be prudent for investors to assume that at least a modest reversal of China's global market share is unavoidable.

## Intensifying strategic competition

Meanwhile at the geopolitical level, relations with the US consistently, and understandably, make headlines. These are framed as strategic competition and an increasingly multipolar balance of power and influence. Since the Ukraine war, China's relations with Russia, including an unwillingness to condemn the invasion while buying its energy, has only intensified strains. Tensions around Taiwan attract particular attention, exacerbated by Taiwan's significance as home to the world's most advanced semi-conductor makers.

For this reason, investors will have to live with proliferating export controls between the US bloc and China. The US and its allies have introduced a range of restrictions designed to thwart China's development in semiconductors. These have left China to develop advanced chip-making equipment by itself. China's disadvantage in the semiconductor sector does not mean that the US bloc will dominate all industries. In the clean energy and electric vehicle sectors, for instance, China has built leads that cannot be reversed by US restrictions.

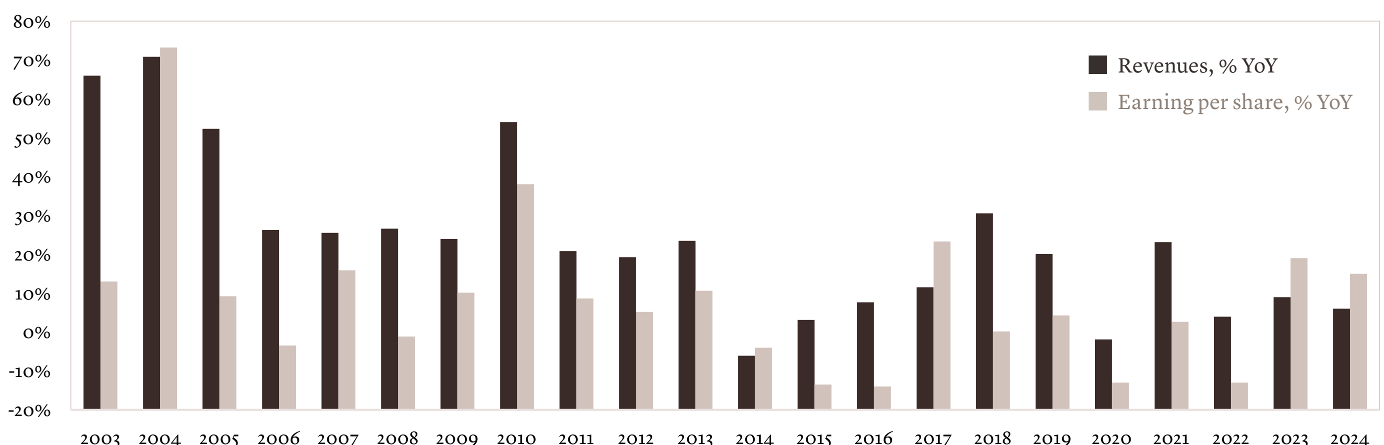
These geopolitical risks have reduced foreign investors' appetite for Chinese assets, with implications for direct investment and prices. Foreign capital flight from Chinese offshore investments is one reason behind disappointing recent returns of offshore-listed Chinese 'H' shares. Between early November 2022 and January 2023, offshore shares experienced a rally as China reopened, outpacing gains in domestic 'A' shares and on the MSCI World index. Year-to-date, offshore shares' performance is essentially flat, compared with a 6% return in mainland China listed 'A'-shares.

## Possible outperformance

Where will Chinese financial assets head from here? The diversification benefits of incorporating Chinese assets into a portfolio remain valid; while Western economies slow, the Chinese economy continues to expand and low inflation means that there is no pressure for the PBoC to tighten monetary conditions. We believe rising domestic consumer spending will translate into improved corporate earnings in the quarters ahead. Worldwide, Chinese products and services are increasingly competitive across a range of industries and technologies, including electric vehicles where it has almost half of the market share.

**A turning point for Chinese firms?**

MSCI China index – historical data and Lombard Odier 2023/2024 forecasts




Sources: Bloomberg, Lombard Odier forecasts

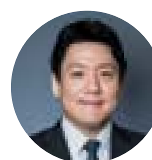
In our view, Chinese equities look poised to benefit from a combination of strengthening growth, low inflation and supportive economic policies. And while our investment case is not based on earnings multiples for Chinese stocks rising this year, we note that they remain attractive relative to their historical averages.

After a rather disappointing first quarter, which was likely affected by a resurgence in Covid cases in December 2022 and January 2023, we expect double-digit earnings growth this year (see chart, page 2). The biggest risk to our earnings outlook is that China's improving growth fails to translate into an improvement in corporate profitability, in part due to ever-persistent price competition. However, there are already nascent signs of margins improving from their two-decade lows, led by large internet firms following cost cuts.

## Bond preferences, weakening yuan

In contrast to our stance on Chinese equities, we see better alternatives to Chinese fixed income, and further weakness to the Chinese currency. We have been underweight both since the fourth quarter of 2022. Chinese government bond performance, compared with global sovereign indices, peaked in October 2022. China's sovereign bonds continue to offer diversification benefits to global portfolios, and given that inflation is not problematic, there is no pressure for the PBoC to tighten monetary conditions. However, a recovery in credit flows should contribute to the cyclical recovery, and be consistent with some upside in yields. Importantly, the level of interest rates currently on offer in Chinese government bonds is low, and we see better opportunities in US Treasuries and other developed market investment grade credit. We also prefer other emerging market assets, including Brazilian government bonds.

China's currency has weakened against the euro, Japanese yen and Swiss franc this year, while remaining relatively stable against the dollar. We expect these trends to continue as many of the drivers behind yuan strength over 2020-22 are now working in reverse: a reopening Chinese economy should result in rising Chinese imports, while global demand for China's exports should decline. At the same time, a recovery in Chinese tourist spending abroad should result in capital outflows from the country.



**Homin Lee**
*Senior Macro Strategist*

**Christian Abuide**
*Head of Asset Allocation*

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