China: Understanding the change of model

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China's economic and financial news have been marked by several important announcements in recent weeks. It's important to analyze them carefully, to try and understand how the country is progressing towards the new growth model it has chosen...

China remains at the heart of global political and economic concerns, as illustrated by German Chancellor Olaf Scholz's recent 3-day trip to China and the 4-day visit of US Secretary of State Anthony Blinken. Nevertheless, China is not currently at the forefront of Western investors' minds, who are focused on US monetary policy and the tense geopolitical situation in Ukraine and the Middle East. It's true that the change of model chosen 3 years ago has cooled investors' spirits. The announcement of "common prosperity" led to numerous regulatory changes, the bursting of the real estate bubble and a fall of almost 50% in the stock market since 2021... The many events of recent weeks give us the opportunity to analyze the progress made towards this new model.

CHINESE GROWTH EXCEEDS EXPECTATIONS

The 1st quarter of 2024 was better than expected, with annualized growth of +5.3%, against an initial consensus of around 4.6%. This gives credibility to the 5% target announced by the government for 2024.

Industrial activity remains solid overall. Investment, up 4.5% year-on-year in the 1st quarter, was supported in particular by public spending. China wants to accelerate investment in advanced technology industries, which will create jobs for young graduates who currently endure a very high unemployment rate of around 20% (there are no longer any statistics on this subject). The country's aim is to become self-sufficient in cutting-edge sectors, freeing itself from the embargoes imposed by the United States, as for the semi-conductor industry, for example. Annual investment in these sectors is estimated at $1600 billion, or 20% of the country's total investment.

Domestic consumption, on the other hand, was disappointing. Retail sales rose by just 3% year-on-year in the 1st quarter. Public confidence was affected by the downturn in real estate, which makes up a large part of household wealth. Households accumulated $1,200 billion in savings in Q1. Real estate remains under pressure: the latest figures show a 9.5% drop in real estate investment compared with the same period last year, with sales volumes down by almost 25%, while house prices continue to fall, by 2% to 5% depending on the city.

In short, the breakdown of this growth shows that the crisis in the real estate sector is not over and is weighing on domestic consumption. A stabilization of the real estate sector is therefore necessary if we are to envisage a more solid recovery, more focused on consumption and in line with the government's objective. Consumption accounts for just 37% of China's GDP, compared with nearly 65% in the United States.

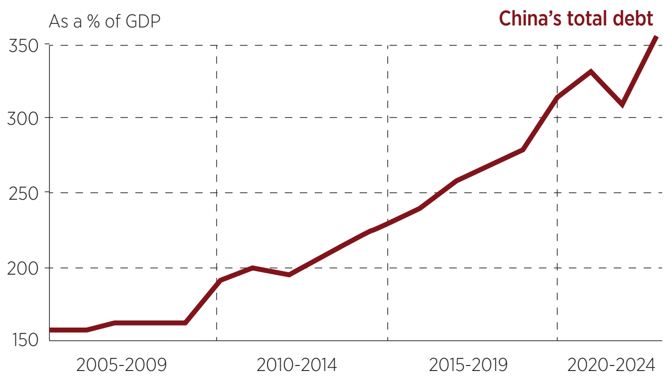
TOWARDS A CHINESE QUANTITATIVE EASING[1]?

Chinese debt has just been downgraded by Fitch. Moody's had already downgraded it last December. Indeed, the debt accumulated in recent years, particularly in the real estate sector, explains this negative dynamic in ratings. Financial risks are increasing, but it should be noted that the proportion of Chinese debt held outside the country

(1) Quantitative Easing: massive purchases of debt securities by a central bank.

is very low, which keeps international systemic risks at bay. China has the means to solve its own problems and seems ready to adopt unconventional monetary measures. China's total debt - corporate, regional and state - is around 350% of GDP, which is comparable to Western metrics.

China's total debt: companies, households, government and local authorities, banks (change over 20 years)



Source: Bloomberg at April 19, 2024

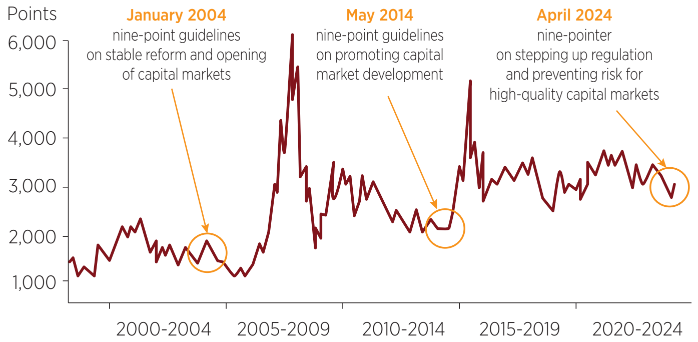
Given this already very high level of debt, the government plans to limit the budget deficit to 3% this year, compared with 3.8% in 2023. On the other hand, monetary policy easing measures, some of them unconventional, are highly likely this year.

Although the RMB is under pressure against the dollar, there is room for further cuts in key rates: the 1-year key rate stands at 2.5%, while inflation is close to 0%. In addition, discussions on whether the PBoC will embark on a policy of quantitative easing (QE) intensified after the publication on March 24 of a series of extracts from President Xi Jinping's speech in which he stated that the PBoC should gradually increase its operations in Central Government Bonds (CGBs) as part of Open Market Operations (OMOs). His original speech was delivered at the Central Conference on Financial Work last October, but this is the first time his statement has been made public. It would also be the first time in almost 20 years that the Central Bank (PBoC) could be active in the Chinese sovereign bond market, with the aim of controlling the long end of the yield curve and providing liquidity. The 10-year yield is currently 2.2%. There is also the possibility of lowering the reserve requirement ratio for major banks, currently at 10%.

THE "NINE-POINT GUIDELINES" FOR STOCK MARKET REFORM

The State Council issued general guidelines for capital markets on April 12. This shows that the Chinese government is concerned about the general level of the stock market and wants reforms to improve market quality and transparency. This is the 3rd capital market directive in two decades. The previous 2 were followed by a recovery of the Chinese stock market (see graph).

Rare Capital Market Document Preceeded Rallies



Source: Bloomberg, April 2024

This version imposes strict regulations on companies entering the capital markets, reinforces supervision of listed companies, securities houses and fund management companies, intensifies regulations on delistings and strengthens monitoring of high-frequency trading... In addition, the "key points" that had been mentioned in 4 policy documents published by the China Securities Regulatory Commission (CSRC) on March 15 have been reiterated: encouraging listed companies to pay active and stable dividends, and to buy back (and cancel) their shares.

These measures are designed to improve the transparency and quality of listed companies, in order to restore investor confidence and attract stable capital back to the stock market.

EARNINGS SEASON BEGINS FOR LISTED COMPANIES IN CHINA

In 2023, earnings from listed Chinese companies were mixed, with an overall increase of 7% for the year as a whole. Last year's results were affected by the real estate and commodities sectors, but outside these two sectors, profits rose by 15%. For 2024, an overall increase of 16% is expected, and this time it should be fairly evenly spread across stocks and sectors. In addition, companies are expected to distribute more to their shareholders in the form of dividends and share buybacks. With 16% earnings growth expected, and a 2024 P/E(2) of around 10, the risk/return profile of Chinese equities looks very decent in absolute terms, and also in comparison with other markets.

(2) Price to Earnings Ratio. A stock market analysis indicator: market capitalisation divided by net income.

In short, China has been in a transitional phase for the past 2/3 years. The mercantilist period of the last few decades, which made China the world's factory with 31% of the world's industrial capacity, is now coming up against a Western firmness illustrated by the tariffs and sanctions imposed by the United States. This will not change, whoever is elected President of the United States in November. China wants to develop on its own, giving priority to the development of its cutting-edge technologies, the green economy, domestic consumption, but also security...

This new path is interesting, but its implementation seems too centralized, more bureaucratic and ideological than before. It is also difficult to understand, given the sudden changes in regulations. There is also a feeling that the entrepreneurial spirit that has made the country so successful in recent years is waning, as is the confidence of young people. This complicated phase explains the deflation of the real estate bubble and the fall in the stock market.

Nevertheless, there is now a political will to resolve these confidence problems by first trying to stabilize real estate, even if this means adopting unconventional monetary policy measures.

And on the financial markets, reforms are aimed at restoring confidence and getting domestic institutional investors, as well as households with abundant savings, back into the stock market.

Will international investors follow suit?

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