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MACRO COMMENT

JUNE 2022

China: more torque, less talk

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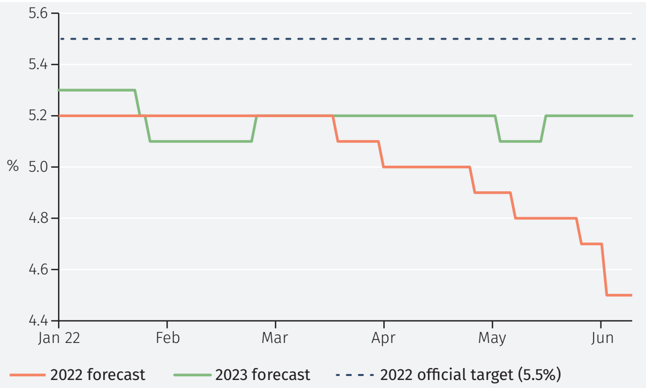
Chinese financial markets have suffered this year against a background of slowing growth and ongoing Covid restrictions. In this edition of *Infocus*, GianLuigi Mandruzzato and Daniel Murray look at recent developments in China's economy and financial markets for clues about a possible turnaround.

The Chinese economic outlook for 2022 has deteriorated as the year has progressed. Since the beginning of 2022, analysts have downgraded forecast GDP growth by around 0.5% and the expectation is now that the economy will expand at a rate nearly 1 percentage point below the government's official target of 5.5% (see Figure 1). In addition to the impact of the war in Ukraine and its influence on international trade and commodity prices, weak Chinese growth also reflects local factors.

1. China forecast GDP growth

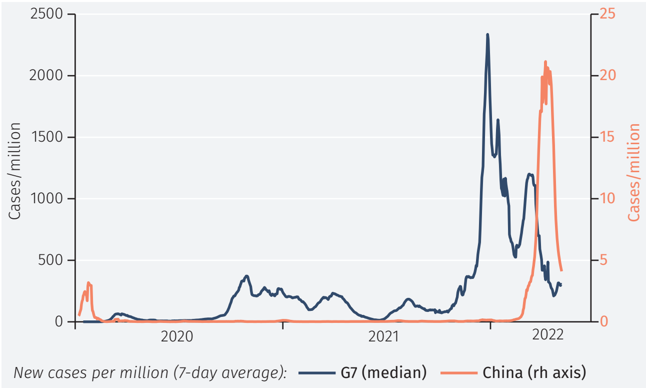


Source: Bloomberg. Data as at 8 June 2022.

Since March, the rising number of Covid-19 cases prompted the Chinese government to impose strict lockdowns in many parts of the country, including Shanghai and the capital Beijing. This is despite the fact that the absolute numbers of infected people have remained relatively low, as shown in Figure 2. However, a concern for the Chinese authorities has been that vaccination rates are low amongst the elderly, hence the tight restrictions, which are thought to have affected about 400 million Chinese people.[1] The measures taken have contained the number of new cases and allowed the authorities recently to announce some relaxation of restrictions in Shanghai and Beijing.

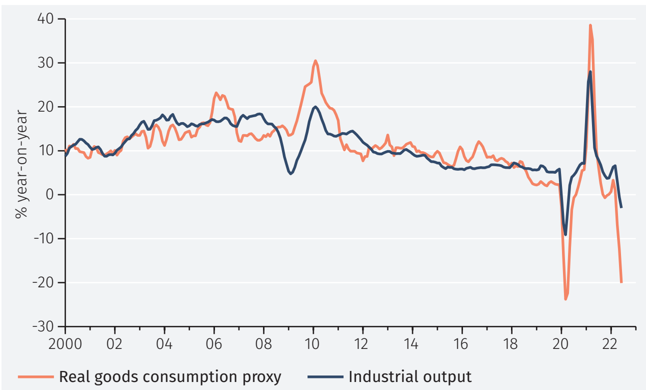
Many commentators do not expect any significant change to the zero-Covid policy before the Communist Party Congress in November when President Xi Jinping will seek a third term. If so, the impact on the economy will be prolonged. Economic data for April, the first period fully affected by the new anti-Covid measures, were weak. PMI indices, retail sales and new car registrations plummeted (see Figure 3). The 20% year-on-year drop in goods purchases was the steepest since early 2020 when the pandemic began. Furthermore, industrial production shrank from a year before. However, recently released PMI data for May showed a marked improvement, especially for the non-manufacturing (services) sector.

2. Covid-19 new cases (G7 and China)



Source: OurWorldInData. Data as at 4 June 2022.

3. Consumption and industrial production



Sources: Refinitiv and EFGAM calculations. Data as at 4 June 2022.

PMI indices are comprised of various sub-indices. The new orders component is often viewed as the one that has the best short term forecasting properties. The weakness in new orders within China's PMIs – shown in Figure 4 - suggests that, without new stimulus measures, Chinese GDP growth looks vulnerable in the coming months.

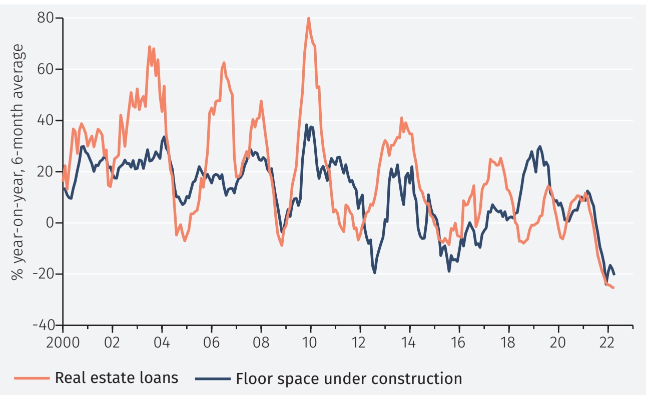
[1] https://qz.com/2164102/nearly-400-million-people-are-under-covid-lockdown-in-china/

4. China PMI new orders

Sources: Refinitiv and EFGAM calculations. Data as at 4 June 2022.

The construction sector has historically been a major driver of activity within the Chinese economy, fuelled by leverage, but that too is now facing headwinds. Policies designed to reduce the excesses of past years were adopted as early as 2021 and have weighed on the construction sector since then - see Figure 5. However, the government recently announced new infrastructure spending plans, something that could help to reinvigorate construction activity within the Chinese economy. Furthermore, Chinese banks have been officially urged to increase lending to the sector.

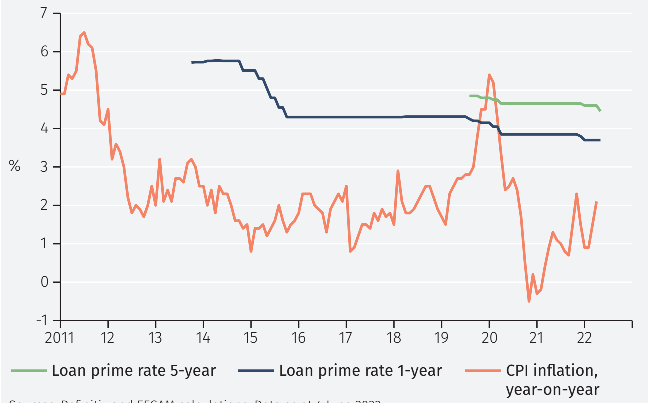
5. Real estate lending and construction



Sources: Refinitiv and EFGAM calculations. Data as at 4 June 2022.

In contrast with the US and Europe, Chinese inflation remains well contained at only 2.1% year-on-year in April, below the official target of 3%. This gives the People's Bank of China (PBoC) and the Chinese government flexibility to provide additional support to the economy. As part of official measures to support the housing sector and the economy more broadly, on 20 May the PBoC reduced the rate on long-term loans by 0.15 per cent to 4.45 per cent (see Figure 6), immediately benefiting the mortgage market. Expectations are that monetary policy will be loosened further. Additionally, Premier Li Keqiang recently

6. Lending rates and inflation



Sources: Refinitiv and EFGAM calculations. Data as at 4 June 2022.

stressed the importance of supporting growth, raising the expectation that more measures will be announced soon.[2]

In fact, the Chinese authorities have announced a whole series of measures to support the economy over the past few months, including 33 that were announced by the State Council on 23 May alone and an CNY 800bn line of credit to support infrastructure projects announced on 1 June. A list of those that we have tracked is included in the *Appendix*.

In announcing these measures, the authorities are trying to achieve a delicate balance between enforcing the zero-tolerance Covid policy whilst ensuring the economy is sufficiently strong to keep people employed and without causing further problems in the housing sector, which is already suffering from problems of excess leverage. This is not easy to achieve and perhaps helps explain why there has been a lot of talk from the authorities but relatively little implemented so far. For example, the tax rebates included as part of the 33 measures announced on 23 May sound impressive but amount to only 0.1% of GDP.

This is one reason why Chinese equity markets have performed poorly in 2022: the economy has been weak and markets have been disappointed by the lack of action, despite all the pronouncements. For the year to 2 June, the net total return from the MSCI China index in US dollar terms is -17.6%, compared to -12.2% and -12.1%, respectively, from the MSCI World and MSCI Asia ex China indices (see Figure 7 overleaf). As illustrated in the chart, much of the underperformance came in early March, since when Chinese equities have performed broadly in line with the rest of the world although in more volatile fashion.

A part of the year-to-date underperformance of the MSCI China index in US dollars can be attributed currency weakness: the

[2] See 'Beijing's stimulus ignores elephant in the room' - *Reuters News*, 27 May 2022.

7. Equity returns in 2022[3]

Source: Bloomberg. Data as at 8 June 2022.

9. P/E ratios

Source: Bloomberg. Data as at 8 June 2022.

renminbi fell by 4.5% against the US dollar in the year to 2 June. In turn, this is associated with the observation that the yield gap between US and Chinese rates has disappeared since the start of the year – see Figure 8.

8. Government bond yields: US and China

Source: Bloomberg. Data as at 8 June 2022.

Chinese equities began the year already trading at a valuation discount to the rest of the world. A consequence of ongoing underperformance this year is that the valuation discount has widened, as shown in Figure 9. Moreover, with a trailing P/E ratio of around 11 and earnings cyclically depressed, valuations look cheap in absolute terms.

In summary, the Chinese economy has been unequivocally weak this year against a background of ongoing Covid lockdowns and problems in the rest of the world. It is not so surprising that Chinese equity markets have underperformed weak global equity markets in this context but what has been disappointing is that the implemented policy response has been so feeble, in contrast with previous periods of crisis. Chinese equity markets look cheap, although valuation by itself is rarely a sufficient catalyst for a market rally. What is now needed is for the authorities to follow through on their promises of supporting the economy. If that were to happen in a credible and sizeable way, the prospects for Chinese equities would improve quickly and meaningfully.

[3] Year-to-date, total returns net in USD

APPENDIX

Chinese policy measures in 2022 to date

16 March	Chinese authorities pledge to support capital markets, support overseas listings, implement measures to help property developers and reduce regulation of mega-cap tech/platform companies.
31 March	Chinese officials announce a plan to create a fund worth a few hundred million renminbi to support troubled financial firms.
14 April	China's State Council said the PBOC will cut the Reserve Requirement Ratio (RRR) "at an appropriate time" and provide support to SMEs hardest hit by the lockdowns.
15 April	PBOC unveils various measures to support the economy including: instructing banks to support LGFVs; lending to people with "flexible employment" such as taxi drivers and online shop owners; cheap loans to SMEs; and targeted re-lending. RRR cut by 25bps.
22 April	China's National Securities Regulator urges institutional investors to buy the market.
26 April	PBOC pledges to "step up the prudent monetary policy support to the real economy, especially for industries and small businesses hit hard by the pandemic". PBOC cuts the RRR for banks' FX reserves.
27 April	President Xi pledges to boost infrastructure spending in areas including transport, energy and water conservation.
28 April	China's State Council vows to provide monetary support for unemployed migrant workers and said local governments should aim to keep employment stable.
29 April	China's Politburo says "We should waste no time in planning more policy tools" and "strengthen macro adjustments".
15 May	Leaked reports that China is planning more policies to support the economy, bolster exports and support tech platforms.
18 May	Chinese Vice-Premier Liu He (most senior economic advisor) said the government will support the development of the digital economy and associated listings.
23 May	Chinese banks cut the rate on long term loans to 4.45% from 4.60%.
24 May	China unveils 33 measures to support the economy, estimated to be worth around 0.1% of GDP and focusing on jobs, consumer spending and SMEs.
27 May	Chinese leaders hold an "emergency meeting" to discuss ways to support the economy.
1 June	An CNY 800bn line of credit to support infrastructure projects is announced.
3 June	China's Ministry of Finance says it will accelerate VAT refunds, make it easier for small companies to bid on infrastructure projects and ensure local governments can easily and swiftly issue bonds.

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