RBC BlueBay
Asset Management

China: recovery delayed, not cancelled

Notes from the road

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Emerging Markets Equity team

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“Beneath the surface, the economy has not yet returned to pre-Covid levels; in fact, far from it.”

Back in Shanghai for the first time since January 2020, it’s surprising how normal things look given the headlines we were all reading last year. The Covid infrastructure that was ubiquitous over the last three years – Covid testing stations, apps & QR codes and the “big whites” – are nowhere to be seen. The city looks just as we remembered it from the last time we were here.

The only practical change from pre-Covid times is a health declaration upon entering and leaving the country, and the fact that around 10% of people are still wearing masks in crowded areas. Beneath the surface though, the economy has not yet returned to pre-Covid levels; in fact, far from it. Shopping malls and restaurants look full, but average spending has still not recovered.

The other change we notice is that consumption has shifted to services from goods. Domestic travel, in particular, has seen robust pent-up demand unleashed. This is understandable, given the lockdowns last year. We also visited Hangzhou, where we observed large queues to the popular local tourist attractions, and we reflected on the fact that tourists from all over China have now returned.

While digitalisation was already present in China prior to Covid, the pandemic has accelerated the growth of digital ecosystems even more dramatically. Paying through Alibaba’s Alipay and Tencent’s WeChat Pay, using QR codes, has become second nature for the vast majority of Chinese. During our visit, we struggled to find merchants who accepted cash. Even street musicians are now using QR codes to collect money. It’s almost impossible to get around without an Alipay or WeChat Pay account as these two platforms, together with UnionPay, are the dominant payment methods in China. According to Statista, there were 1.2 billion active users of either AliPay or WeChat Pay in China, as of 2020, and over 90% of mobile payments in the country are made through these two platforms[1].

[1] Alipay vs WeChat Pay users | Statista.

To put this into perspective, the total population of China is around 1.4 billion people. This means that over 83% of inhabitants use the platforms. China is gradually marching towards a cashless society.

We have also seen digitalisation trends accelerate beyond the digital payment system. Dealing with daily affairs is only an app away. When we landed in Shanghai Hongqiao International Airport, we ordered a phone charging cable on Meituan's e-commerce app, China's largest on-demand service platform[2]. The parcel was delivered to the hotel before we arrived and was stored in one of Meituan's smart pickup lockers outside the hotel, which can only be opened with a pickup code sent by the company.

On our way to a management meeting in Shanghai, we came across a 24/7 smart drug vending machine in the office lobby. Next to the vending machine was a $3m^2$ booth called 'One-Minute Clinic'. This is a new operating model set up by Ping An Healthcare, China's largest online healthcare service provider[3], together with a leading domestic drugstore chain. In the 'One-Minute Clinic', patients can speak to an 'AI doctor' about their symptoms and medical history through voice and text inputs. A human doctor will then offer remote diagnoses, medical advice, and online prescriptions based on the information provided. Prescribed drugs can be purchased in the vending machine or ordered through the Ping An healthcare app.

> **"Over 83% of the Chinese population uses either AliPay or WeChat Pay. China is gradually marching towards a cashless society."**

Tourists at Hangzhou's top tourist attraction, Lingyin Temple.

Smart pickup lockers for contactless delivery.

Back to the economy, two things have shaken the confidence of the affluent middle class. Firstly, strict lockdowns and then a sudden U-turn have brought into question government competence. Secondly, the weak real estate market has also hit sentiment, given that it accounts for most of China's middle class wealth.

During our two-week trip to the Yangtze River Delta region, many of the management companies we met told us that recovery in the first five months of 2023 had been weaker than hoped, but that they expect a strong second half of the year, as confidence recovers. Unlike previous cycles, there seemed little expectation of significant fiscal or monetary stimulus from the government. This could therefore be an upside surprise.

There is no doubt that the government is acknowledging this weakness, and official rhetoric has turned positive towards the market, and even towards property and the internet sector. Premier Li Qiang, the previous party secretary of Shanghai from 2017 to 2022, has a reputation for being pro-business and market friendly. During his time as the leader of Shanghai, he developed relationships with many business leaders, and by all accounts has been tasked with trying to revive consumer and business confidence. We have seen a pro-growth policy orientation ever since he was appointed as Premier, in March of this year. A recent meeting with business leaders from the major internet platforms, including Alibaba, Tencent, Baidu and Meituan, is a good example. Again, questions centered on policy follow-through and implementation remain.

1 Alipay vs WeChat Pay users | Statista.
2 Meituan - statistics & facts | Statista.
3 Healthcare Ecosystem | Ping An Group.

'One-Minute Clinic' and a smart drug vending machine.


Test driving the new NIO ET7.

The other concern currently is China's local government debt risks, which are related to the property sector. Local governments had the double whammy of higher costs due to Covid containment last year, as well as lower revenue from the decline in land sales due to the property crisis. This is starting to put some weaker local governments under fiscal pressure. There continue to be rumours about certain local governments being unable to repay bonds on time.

While this is concerning, it is by no means new in China. In the recent Politburo meeting, which took place in July and which typically sets the central government's economic policy tone for the second half of the year, policymakers said they will formulate 'a basket of plans' to address local government financing issues. We therefore expect central government to intervene in some cases and restructure local government debt terms, using its own balance sheet to guarantee payments. In return, we should see more local government reforms to end the old model of debt-fuelled infrastructure spending, in order to hit GDP targets.

On the positive side, we are starting to see the impact of the government's focus on improving overall consumption. Retail sales were up 6.7% year-on-year in the first half of this year[4], and are continuing to recover from last year's lockdown, albeit slower than initially expected. The bright spot has been auto sales, which recovered to 2.26 million units in June, from a low of less than one million units during the Shanghai lockdown last year[5]. Of note is that electric vehicle ("EV") penetration continues to grow rapidly. EV sales accounted for around 5% of total passenger vehicle sales in 2020, increasing to 25% last year[6], and are expected to rise to over 30% by the end of 2023[7].

The MSCI China Index is down 22% from its peak in January, and now trades at 9.7x forward P/E[8], which reflects the weaker-than-expected rebound. Our view is that investors will need to be more patient in China. Hopes for a sharp rebound, driven by 'revenge consumption', have clearly been dashed. However, as the trauma of lockdowns and the property market crisis recede, and government pro-business rhetoric turns into policy on the ground, we expect the economy to continue to gradually recover as consumer confidence improves.

"We expect overall growth to continue to trend down, now that the government is shifting away from its previous debt-fuelled growth."

Over the longer term, the fact that the government has refrained from all-out stimulus is a good thing, in our view. We expect overall growth to continue to trend down, now that the government is shifting away from its previous debt-fuelled growth. If this means China's economy becomes more consumer-led rather than infrastructure-led, we see this as a positive, from a long-term equity market perspective. This is because less overcapacity and a stronger consumer should translate into improved margins – and thus – returns.

4 Bloomberg Economics, 18 July 2023.
5, 6 Bloomberg New Energy Forum, 18 July 2023.
7 Gavekal Dragonomics, 28 July 2023.
8 As of 26 July 2023.

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