RBC BlueBay Asset Management

Polina's Perspective

Recovery with Chinese characteristics

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Have you ever lived through a crisis? Most of us have experienced a crisis, either personally or professionally. In August 1998, I was – at my mother's request – stocking up on toothpaste and toilet paper in a supermarket in New York before flying back to Russia, after the country defaulted on its debt.

While a crisis experience can be frightening at times, it can also be accompanied by a sense of hope that it will be short lived, with optimism that policymakers will find a solution to engineer a prompt recovery. Private entrepreneurs can also play a big role, often stepping in to take advantage of opportunities following the crisis. From a return perspective, these opportunities tend to present amongst the best internal rates of return for investors.

Yet in China, a crisis seems to have different characteristics. I flew over to the country this summer to spend a few days on the ground visiting several provinces, meeting local and central government officials as well as companies' management and private entrepreneurs, to get a better sense of a path towards recovery.

Following the trip, we remain underweight China's hard currency debt in both corporate and sovereign funds, given relatively tight valuations. We have a neutral view on local currency debt. Unlike other countries, we feel that a post-crisis China has not presented investors with an opportunity to generate attractive returns. Here is why:

China's central government has, to some extent, self-engineered a crisis in the real estate sector by imposing several measures to tackle corruption and the accumulation of leverage. The introduction of 'three red lines', alongside an anti-corruption campaign, was designed to remove excesses from the economy in a controlled manner.

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Based on my observations, crisis management and the path for recovery in China differ from that of other market economies. Select macro data, such as GDP growth or export statistics, indicate a steady recovery. The country is also seeing a positive trend in other sectors of the economy that are being prioritised by the government.

Yet these numbers are at a sharp contrast to local sentiment and weak consumer demand. What is the cost of pro-active crisis management? Can one be as effective in engineering a recovery, as well as a downturn?

The Chinese government has presented a well-articulated plan for economic recovery. The party line to us from the policymakers is clear – the decline in the real estate sector, which translated into 3.7% drag on GDP growth, was more than offset by a pick-up in high tech, green and digital sectors that contributed 5.7% to the GDP growth this year[1]. This includes certain sectors, like solar panels and lithium battery production, where exports are growing at rates well above 20% year-on-year[2]. However, this narrative does not appear to reflect the sentiment on the ground.

Firstly, this is due to the fact that in certain sectors, export recovery is delivered at the expense of cost and margin reduction. A large number of state employees have received salary cuts to keep costs under control. Moreover, compared to private enterprises, state owned firms are able to withstand more margin pressure in order to deliver targets set by the government. China manufactures 30% of the world's goods but China's population is nearly 20% of the world[3].

Therefore, maintaining healthy export growth is a key policy objective. This partially explains why Chinese export volumes to EU and US destinations continue to grow, despite growing export tariffs. Given export growth remains a government priority, we do not expect an aggressive response to further tariff hikes from China, either through a sharp currency devaluation (that would damage the CNY's longer-term path towards a reserve currency) or through counter measures that could result in product shortages.

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Secondly, the pace of the recovery is also affected by the negative sentiment within the private sector. Foreign players might be less affected by cost cuts and margin pressure, but they are still feeling the growing burden of bureaucracy. Anecdotally, some companies are voicing concerns that the volume of regulatory breaches has increased over the last few years, despite continuous engagement with the government to lower the numbers.

Some local private players also express their concern over a growing burden of bureaucracy. One local entrepreneur, with interests in manufacturing and real estate, summarised the new approach of policymakers when it comes to engagement with business owners, as follows: "The less you do, the fewer mistakes you make". It isn't surprising, therefore, that privately owned companies are also failing to provide stimulus for a faster economic recovery.

Thirdly, the level of mistrust between the local and central government leads to the latter being reluctant to channel more funds to the former to partially offset the reduction of revenues from land sales in the troubled real estate sector. The mistrust stems from a perception of mismanagement of generous funding received by the local government in the pre-Covid period.

As a result, the central government is focusing either on supply-driven incentives to stimulate the real estate sector by reducing borrowing rates and increasing lending facilities to the developers on the white list, or on demand-driven incentives by reducing down-payments and improving mortgage availability. The problem, however, is that these measures are simply not enough to engineer a robust recovery.

There are also some structural challenges to manoeuvring a quicker rebound in China. One of them relates to overcapacity in certain sectors and lack of consolidation. For example, instead of 10 larger private players producing electric vehicles, China has over 200 companies in the sector, which leads to price wars and margin erosion.

Another challenge relates to demographics but goes beyond the ageing population and rather focuses on the differences between students in rural areas versus the cities. Based on a 2023 study published by Scott Rozelle from Stanford University, students in rural areas with the same level of educational facilities and nutrition show lower results in nationwide tests than their counterparts who grew up in the city. The difference seems to be driven by the lack of mental stimulation of rural children in earlier years of their development that negatively contributes to their cognitive skills and attainment later in life.

Finally, continued global geopolitical tensions are also creating a sentiment of mistrust between China and the West that negatively weighs on sentiment both within China, and between China and its trade partners.

What gives us room for longer-term optimism? A number of key factors: firstly, for better or for worse, the work ethic in China is the strongest amongst any other country that I have visited in emerging markets. For example, some senior government officials only have five days of holiday a year and are accustomed to working long hours and six-day weeks away from home.

Separately, we are encouraged by the market understanding and economic vision of several members of the politburo like Yuan Jiajun (party secretary of Chongqing) and Chen Jining (party secretary of Shanghai) but, in our view, the transition is likely to be at least five years away. In the meantime, we would expect a continuation of the current slow pace of Chinese recovery.

[1,2] Ministry of Finance.

[3] China accounts for 30% of global manufacturing output (scio.gov.cn), China population (worldometers.info).

That said, it is important to acknowledge that even at a slower pace of growth, China is still generating an annual increase in GDP equivalent to the size of total GDP growth of the European Union and, hence, remains a global force to be reckoned with.

Often when countries go through crises, while economic hardships are unavoidable, investors tend to find ways to benefit from the recovery story and, consequently, partially contribute to a faster path towards normalisation.

China's pro-active crisis management, which was exemplary, especially at the outset of Covid, also created a different path towards recovery that offers investors less optimism with respect to generating strong returns in the near future.

Having said that, whilst recovery with Chinese characteristics is likely to take longer than investors might have patience for, it is equally unlikely to cause high asset price volatility either within or outside of China.

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