Structural problems hinder growth...

Dear reader, The Chinese economy has not sustained a robust recovery following the lifting of strict COVID restrictions as anticipated. The 4.5 percent annual GDP growth in the first quarter initially sparked hopes of a stable upward trend. However, recent economic indicators have been disappointing.

Industrial production in April remained relatively stagnant compared to the previous month (+0.12%), and the year-on-year comparison lacks significance due to the lockdown in the crucial economic region of Shanghai in April 2022. Similarly, retail sales only saw a marginal increase of 0.49 percent compared to the previous month, down from 0.78 percent in March.

While these figures may not appear alarming and could be temporary setbacks after months of relatively strong performance, they align with weaknesses observed in other areas. The decline in imports by 7.9 percent in April compared to the previous year confirms a flattening domestic demand. Additionally, export growth has not been as dynamic as expected, despite diminishing supply chain constraints. The purchasing managers' index for the manufacturing sector has fallen into contraction territory, with new export orders experiencing a significant downturn.

Low inflation rate signals weakness

Recently, executives from U.S. companies such as PepsiCo, Qualcomm, and Cummins expressed cautious outlooks on growth prospects in China. Calls for more expansionary monetary policies and increased government stimulation of the economy have grown louder, not only within China but also internationally. At first glance, such calls are far from unreasonable. While Europe, the United States, and many other countries continue to grapple with high inflation, China is facing a potential threat of deflation. In April, the consumer price inflation

rate fell to a meager 0.1 percent:

Producer prices have also continued their downward trend in April, with a decline of 3.6 percent in recent months. This reflects the limited pricing power of companies in the face of weak demand.

In the past few decades, stimulating the economy through easier credit conditions and state investments has generally proven effective. However, this approach has led to significant structural problems that would only worsen with a reiteration of such policies. Moreover, the success of these measures is questionable as the aforementioned structural problems act as growth inhibitors.

The combined debt of the government, corporations, and households is currently three times higher than the current GDP. Beijing has recognized the resulting risks to financial system stability in recent years and gradually tightened credit access. This has placed many real estate companies in financial distress and led to difficulties for private households. Although some easing measures have been implemented for some time now, it is unlikely that a departure from this stability policy will be fundamentally adopted. Additionally, there are limitations to boosting the economy through increased investments in infrastructure and industrial capacity. The National Bureau of Statistics itself indicates that inadequate demand is limiting the industrial sector. Further capacity expansion would be counterproductive.

Consumers are uncertain

Instead, the declared objective is to strengthen domestic demand, which would make China less reliant on export markets and, not least, on the United States, an important political concern. However, this has not worked as desired thus far. While the affluent continue to purchase luxury goods, the majority of Chinese consumers are exhibiting restraint in their spending. More money is being allocated towards travel and services now that they are once again possible, while savings are being prioritized over larger purchases in other areas.

The primary reason for this is that the anti-COVID policies have resulted in job losses and created significant uncertainty. Additionally, the increase in interest rates for loans and dashed hopes of homeownership have further contributed to the situation. Youth unemployment remains at 19.5 percent, and despite some signs of economic recovery, it has not translated into a significant improvement in the job market. This is despite China also grappling with an aging population.

In short, private consumption has not been a driver of growth in China in recent years, and it does not appear that this will change in 2023. Since 2017, household savings have exceeded new loan disbursements, effectively withdrawing money from the economic cycle. This trend has intensified significantly since 2022. Fear of the future is one factor, but another is the correction of a misdevelopment: Household debt has risen from 20 percent of disposable income in 2009 to the current level of 100 percent.

Injecting more liquidity into the system will not solve this structural problem nor encourage households to increase consumption. Building trust is crucial, including trust in job security and property financing.

Foreign investors remain cautious as well

The Chinese stock market is burdened not only by disappointing economic performance but also by the restraint of primarily long-term foreign investors. There is significant uncertainty regarding how to assess the risks of escalating confrontation with the United States, potentially leading to a military conflict. The strict sanctions imposed on Russia served as a clear warning to many investors.

Furthermore, the subdued performance of the Chinese stock market since the initial rally following the end of the zero-COVID policy does not add to the sense of urgency. At present, investors do not feel that they are missing out on opportunities, so it seems better to adopt a wait-and-see approach.

Figures on China-focused funds based in the United States reveal that their fund volumes hit a record low in October 2022, marking a downward trend that has persisted for the past four years. HSBC Research suggests that global funds are underweight in China, and the lackluster performance of the MSCI China Index in recent years compared to indices like the MSCI World reflects these numbers.

Amidst all the negative aspects, there are also positive developments. Property market sales have recently seen an uptick, indicating that the market may have reached its low point. However, due to the ongoing financial issues faced by many property developers, this sector is unlikely to contribute significantly to overall growth. Furthermore, the demographic decline in the working-age population will dampen demand in the construction sector in the long run.

My conclusion is that unlike previous periods of global economic weakness, such as after the 2008 financial crisis, China cannot currently serve as the global economic engine. The country would require impulses from increased export demand, which are not foreseeable at the moment, at least not to a sufficient extent.

Debates continue regarding the extent to which the structural problems, political risks, and disappointing post-COVID dynamics are already factored into stock prices. Many stocks are undervalued to some extent. However, volatility in the stock market has increased due to the restraint of long-term foreign investors, and further declines cannot be ruled out, especially if there is a more severe recession in the crucial U.S. market.

Nevertheless, China remains a region with above-average growth rates in the long term. Despite all the challenges, it is expected that GDP will grow by more than 5 percent in 2023. In our long-term portfolio, we do not want to miss out on the opportunities that arise from this, but we also do not overweight China, as political risks, in particular, should not be ignored.