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ECONOMIC NEWSLETTER

CHINA'S ANTICIPATED ECONOMIC REBOUND FALLS SHORT

At the onset of 2023, China seemed poised to regain its footing in global markets, with many economists and commentators expecting the Emerging Market to experience a year of buoyed economic and market growth. Six months into the year, whilst China has experienced positive growth, it has certainly not been to the degree that was anticipated. Year-to-date Chinese equities have lagged their developed market counterparts, with the ACWI 15% ahead of the Chinese market, eroding investor sentiment and fuelling a bearish narrative.

After nearly three years of their draconian zero Covid-19 policy, involving strict measures including widespread testing, contact tracing, quarantine of infected individuals, travel restrictions, and extreme lockdowns in affected areas, mainland China began to phase out the policy in December 2022, allowing the population to return to normalcy. Widely regarded as one of the strictest, longest-lasting policies in the world, the end of the regime was expected to propel China forward as an investment destination.

During the lockdowns Chinese consumers significantly decreased their levels of discretionary expenditure, allowing the population to considerably increase their personal savings. By the end of 2022 and the zero covid-19 policy, the average Chinese citizen, by now sitting on a fairly sizable pile of disposable cash, was expected to deploy their cash reserves into the newly-opened Chinese economy. As such, a broad-based consumption recovery, particularly in the service sector (items such as leisure and travel), was expected to occur in 2023. The recovery was expected to boost Chinese stocks exposed to consumption expenditure, leading to a marked increase in earnings power. This earnings resurgence, coupled with the favourable policy and cheap valuations, was expected to propel China into an equity bull market. Resultingly, many multi-asset portfolios increased their geographical exposure to China, eager to participate in the expected growth.

The start of 2023 was not met with the euphoria many investors expected to emanate from the Chinese economy as well as the Chinese consumer. Average expenditure within China, whilst certainly ahead of the levels during the Covid-19 pandemic, disappointed on the downside. Relative to pre-pandemic levels, consumption remained fairly muted.

By the end of the second quarter of 2023 sentiment surrounding Chinese assets has been considerably eroded, and asset prices have muddled along without bringing the elevated returns that were expected.

MESSAGES FROM THE STOCK MARKET

On a relative basis, Chinese stocks have had a tough start to 2023, underperforming their developed market counterparts as well as their emerging market peers. Forward earnings have shown some positive growth, with the CSI300 (a stock market index composed of 300 large-cap A-shares listed on the Shanghai and Shenzhen stock exchanges. It represents a broad cross-section of the Chinese stock market, including both blue-chip and mid-cap companies) growing its earnings by 9% year-to-date.

This earnings growth has been largely driven by the consumption sector (as expected), along with the services and export sectors. The primary drag to sustained growth remains focused in the manufacturing sector, which is largely state-controlled and geared towards property construction and infrastructure.

The positive earnings growth has yet to be fully reflected in Chinese stock prices, however economists are now uncertain as to whether we will see a marked increase in Chinese stock prices this year.

Despite the mediocre stock returns, the overall Chinese economy is growing at trend and is in line with their 5% targeted GDP growth rate.

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MESSAGES FROM THE BOND MARKET

Relative to its developed market counterparts, China has maintained a fairly easy Monetary Policy, keeping its two primary interest rates, the MLF and the LPR, unchanged for nine months. In mid-June, the People's Bank of China (PBoC) cut both rates by 0.10% to provide a degree of stimulus to the economy. Cutting rates, while stimulatory for the economy, erodes the yield earned by money market and fixed income instruments. When interest rates decrease, the yields on newly issued bonds also tend to decrease, as new bonds are typically issued with lower coupon rates (the fixed interest payments) to align with the prevailing lower interest rates in the market.

Due to the prolonged loose Monetary Policy employed by the PBoC, bonds yields in China have been on a steady decline since late-2020, with the Chinese 10-year government bond yield now a full per cent lower than the comparative 10-year government bond yield in the US. As a result of the reduced yield, foreigners have dumped close to $150bn of yuan bonds over the last three months, opting instead to deploy their cash in higher-yielding emerging market bonds, or moving to US Treasuries.

A WORD ON INDIA

In contrast to China, the Indian economy has seen marked growth in 2023, with the iShares MSCI India ETF up over 10% in the second quarter. Having taken over China as the most populous country in the world, India is now the fifth largest stock market globally after the US, China, Japan, and Hong Kong.

Despite the $4.9bn inflows of foreign investment into India over the second quarter of 2023, investors should remember that India is not immune to global macro-economic risks, particularly over the short term. Indeed, analysts covering the Indian stock market have warned that valuation risks are becoming stretched due to the recent surge in stock prices, which in many cases have run ahead of their fundamentals. As such, any exposure to the Indian stock market should be scrutinised and should be viewed on the high-end of a portfolio's risk exposure.

As investors, we are continually reminded at how difficult (many would argue impossible) it is to time the market, be it on the upside or the downside. A strong overweight allocation to China relative to developed markets at the start of 2023, in anticipation of increased economic and earnings growth, would have caused a lag in performance relative to peers year-to-date. Valuations, whilst helpful for defining risk parameters, are often poor timing tools. Many would argue that EM stocks are cheap from a valuation perspective, however this has been the case for a protracted period. As such, a pragmatic and well-established investment process should underpin any investment decision, whether it be on a stock-specific, index, or geographic basis.

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