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Monthly Market Views

International Private Banking Division

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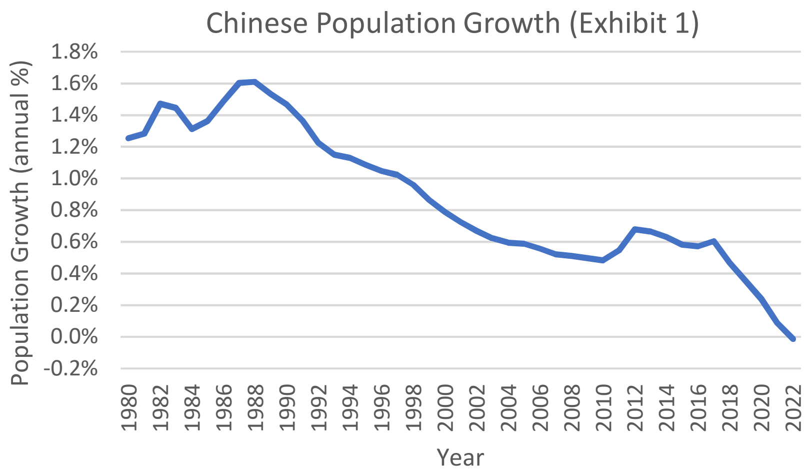
As investors navigate todays financial markets, an enduring source of uncertainty has been the slowing Chinese economy. How should investors think about the potential development of this theme, as it relates to broader portfolio construction?

For the past four decades, the Chinese economy has relied on investment to fuel economic growth. This model of expansion allowed China to grow and achieve urbanization at a record pace, supported in-part by an ever-growing housing market; which at its peak in 2021 represented approximately 25%[1] of Chinese Gross Domestic Product (GDP). Along with an expanding housing industry, the Chinese economy has relied on significant investment-led growth from state-owned enterprises (SOE).

As the mass migration to cities transpired during the 1990s - early 2000s, infrastructure and housing investment helped support it. However, while migration has slowed and population growth has turned negative (Exhibit 1)[2], supply-side focused economic growth has continued, due to various economic and political constraints. Since the early 2000's, the result of the dwindling economic benefits of additional capital spending has been a significant increase in non-financial debt, which has growth from 139% of GDP in 2008 to 297%[3] at the end of 2022.



Although news headlines about China's woes have appeared regularly recently, the core of China's economic issues are not a new development. While the broad solution to China's slowing growth appears straight forward. Essentially involving transitioning from an investment-led growth model to a consumption-led one. The implementation of this transition has so far remained out of reach. The Chinese "growth miracle" of the past 40 years has forged influential institutions across political and business sectors, that benefit from current government policies, and appear highly reticent to change. As a result, instigating a shift in this established framework demands a level of effort exceeding the ideological transition that is being publicized internally today.

> Unless Beijing…implements a massive transfer of income from local governments to the household sector, which is hard to do, there is simply no way to revive growth sustainably. Low confidence is the consequence, not the cause, of China's economic malaise. – Michael Pettis, Carnegie Endowment. 8/27/2023

[1] https://www.caixabankresearch.com/en/sector-analysis/real-estate/chinas-real-estate-sector-size-does-matter
2 https://data.worldbank.org/indicator/SP.POP.GROW?locations=CN
3 https://www.caixabankresearch.com/en/sector-analysis/real-estate/chinas-real-estate-sector-size-does-matter

It's nearly impossible to predict economic outcomes with certainty over an extended period of time. However, as investors, it's prudent to make decisions based on probable outcomes. Based on the underlying fundamentals of China's economy, and the trajectory of events, we believe that the below represent relatively likely scenarios -

- Short Term – Chinese regulators have recently taken a number of steps to boost investor confidence in financial markets[4]. These have included cutting the stamp duty on stock purchases by half, decreasing the minimum margin ratio required for buying securities, and encouraging securities firms to lower stock trading commissions. Outside of financial markets, local Chinese governments are set to launch a significant number of construction projects after fast-tracking their full-year 2023 bond issuance to Q3[5], None of these measures address the larger issues of inadequate income share for the household sector. They do however indicate that local authorities are willing to step-in to support necessary institutions and practices in the short-term.
- Medium Term – Like many global industrial economies, Chinese manufacturing receives significant direct and indirect subsidies. In the case of China, the level of indirect subsidies are among the highest in the world; Ranging from a weakened currency, to abundant infrastructure, to supportive labor policies. These factors should continue to make China a manufacturing powerhouse for global export.
- Longer Term – Given the unpredictable nature of human events, we put the least amount of weight into long-term predictions. However, one likely scenario that would correct China's underlying inbalances involves an extended period of slow growth and internal redistribution of resources; a scenario generally referred to as "Japanification"[6].

Combining the uncertainty surrounding China's economic prospects with the uncertainty surrounding the path of US interest rates, adds to an enhanced level of macro uncertainty and volatility. From an international investment prospective, a slowing Chinese economy is likely to have a direct negative affect on commodity demand. The timing will of course depend largely on the Chinese authorities ability and willingness to "kick the can down the road" by continuing to implement supply-side stimulus measures.

In general, however, data seems to be pointing to a benign end of 2023; with a number of positive tailwinds including –

- The US Federal Reserve's monetary tightening appears to be largely complete, with inflation having recently moved toward (albeit slightly above) target.
- US corporate earnings remain relatively robust, as consumer spending and overall health remained positive surprises in today's higher interest rate environment.
- Simultaneously, as we noted earlier, Chinese authorities are continuing to act decisively to stimulate growth. As long as this is the case, highly correlated sectors such as commodity exporters, are likely to participate.

The culmination of these factors, leads us to believe that investors should focus on quality businesses with robust balance sheets in less cyclical industries. And on the fixed income front, continue to follow a barbell approach, taking advantage of cycle-high short-term rates, while locking in longer-term yields.

[4] https://www.chinadaily.com.cn/a/202308/28/WS64ecb8d6a31035260b81ea8e.html
[5] https://www.scmp.com/economy/china-economy/article/3232720/chinas-record-annual-limit-infrastructure-boosting-bonds-be-spent-october
[6] https://www.ft.com/content/52c805d5-c759-46cc-a0fe-2de2f2d71850

Economic Overview

	GDP Forecast (2023)	GDP Forecast (2024)	Inflation Forecast (2023)	Inflation Forecast (2024)	IG Credit Downgrade
Argentina	-2.5%	0%	120%	126%	N/A
Brazil	2.4%	2%	5%	4%	N/A
Chile	-0.2%	2%	8%	3%	Low
Mexico	3.0%	2%	6%	4%	Medium
Peru	1.5%	3%	7%	4%	Low
Uruguay	1.0%	3%	7%	6%	High
Israel	3.1%	3%	4%	3%	Very Low
USA	2.0%	1%	4%	3%	Very Low

Data Source: Bloomberg Terminal, as of September 6, 2023

Market Overview

Equity		Foreign Exchange		Fixed Income	
S&P 500 Index	17.2%			Global High Yield	6.1%
Nasdaq Composite	32.0%	USD	1.4%	Global IG Cor: 50%	2.4%
Euro Stoxx 50 Pr	14.6%	EURUSD	0.0%	US Corp. High Yield	6.6%
FTSE 100 Index	2.8%	GBPUSD	3.3%	Corporate (USD)	1.5%
Nikkei 225	28.0%	USDJPY	-10.9%	EM High Yield	4.5%
Hang Seng Index	-5.0%	USDCNY	-5.9%	Investment Grade	1.3%
Brazil Ibovespa Index	5.7%	USDBRL	6.1%	Treasuries	-2.1%
S&P Merval Tr Ars	180.3%	USDARS	-49.4%	U.S. Treasury	-0.3%
S&P/Bmv Ipc	10.7%	USDMXN	11.1%	Sovereign	2.9%
MSCI ACWI	14.2%			Global Aggregate	-0.8%

Data Source: Bloomberg Terminal, as of September 6, 2023

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