State of Play

21 October 2021

Our Investment Specialist, Simon Durling, shares his thoughts in our latest update. The latest disappointing quarterly economic growth numbers highlight the challenges facing the Chinese economy as it emerges from a crisis which has brought about long lasting changes in how the world trades with each other.

Economic revolution

Following radical reforms in 1979 the Chinese economy has grown on average 9.5% per year up until the pandemic began. This pace of change and subsequent growth was previously described by the World Bank as 'the fastest sustained expansion by a major economy in history'. China has grown to be the second largest economy in the world, the major trading partner of the United States (US) and the largest foreign holder of US debt which has helped fund additional US borrowing and keep US interest rates lower for longer. Many economists attribute much of China's rapid economic growth to two main factors: large-scale capital investment in infrastructure (financed by large domestic savings and foreign investment) and rapid productivity growth through technological advancement. These two factors appear to have gone together hand in hand with other economic reforms which led to higher efficiency in the economy, boosting output and increased resources for additional investment in the economy.

Globalisation

Globalisation is the growing interdependence of the world's economies, cultures, and populations, brought about by cross-border trade in goods and services, technology, and flows of investment, people, and information. At the forefront of this, and arguably the driving force, of this 40-year transformation is China. Offering state of the art manufacturing and technology capabilities to companies globally at significantly lower labour costs has seen it become the world's largest manufacturer of goods. And yet the Chinese economy grew 4.9% in the quarter July to September when compared with a year earlier, representing the slowest pace in a year and well below the 6-6.5% target range set by their government over the last few years.

A combination of factors contributed to the slowdown in growth but the biggest have been soaring commodity and energy prices and the impact of central government pressurising regional administrations to reduce their carbon emissions in line with the country's goal to be carbon neutral by 2060. The power crunch, which has seen local government ration electricity triggering blackouts for both individuals but also factories, couldn't have come at a worse time when poor weather in the Shanxi region, which is the largest producer of coal, suffered torrential flooding reducing coal supply to both power stations and factories across the country. The power cuts have disrupted many industries in the country, particularly those that use a large amount of energy, including cement production, steel and aluminium smelting. Factory gate pricing, which measures what manufacturers charge wholesalers for goods, grew at the fastest pace in 25 years hitting 10.7% in September and fuelling longer-term inflation concerns.

The pandemic has forced many companies across the globe to review their supply lines, with some choosing to bring back onshore many of their manufacturing processes, thus diverting investments away from China and other emerging market economies. The trade war during former US President Donald Trump's tenure didn't help matters as he made many decisions to incentivise US companies to build products in the US to create domestic jobs and bypass China. This de-globalisation momentum had already begun before COVID-19 emerged, but the pandemic has exacerbated the trend.

Government intervention

Over the last few months President Xi Jinping's government have made several significant announcements, introducing new regulations and enforcements of existing rules targeted at the country's biggest companies. These are part of a wider centrepiece initiative known as 'common prosperity'. Key to the policies are Beijing's attempts to narrow the huge wealth gap between the nation's richest and poorest citizens. In the year that the Chinese Communist Party celebrates their 100th birthday these latest measures are seen by some as a way to rein in the billionaire owners of some of China's biggest companies to instead give customers and workers more of a say in how firms operate and distribute their earnings. Technology companies have been a key focus with Chinese Government actions including crackdowns on ecommerce firms, online finance services, social media platforms, gaming companies, cloud computing providers, ride-hailing apps, and cryptocurrency. All of this has created uncertainty for international investors which is reflected in the comparative performance of China's stock markets versus other markets globally since the start of the year. The main US index, the S&P 500 has returned just shy of 20% year-to-date in comparison to the FTSE China 200 index which has lost 3%.

Property troubles

China Evergrande Group is the second largest real estate development company in China. Evergrande owns more than 1,300 real estate projects in over 280 cities in China. Its property services management arm is involved in nearly 2,800 projects across more than 310 cities in China. The company has seven units dabbling in a wide range of industries, including electric vehicles, health-care services, consumer products, video and television production units and even a theme park. The firm says it has 200,000 employees, but indirectly creates more than 3.8 million jobs every year, according to its website. Over the last few weeks investment markets have been concerned about the $300bn debt pile Evergrande has built up during a rapid expansion in the last few years.

Beijing has introduced new borrowing limits as part of the common prosperity goal, hitting Evergrande hard as it struggles to raise additional borrowing to meet its debt obligations. The firm has seen more than 80% wiped off its stock market value in just the last six months and its credit rating and reputation has been hit as many banks refused to lend to Evergrande exacerbating the cash flow problems. Under the common prosperity policies, authorities seem more likely to help buyers of Evergrande's properties and the customers of its wealth management business rather than the company itself and its other creditors like bond holders and banks.

This notion was supported just this week when China's central bank, without directly mentioning Evergrande, vowed to protect consumers exposed to the housing market. Fitch Ratings downgraded Evergrande's debt last month and said 'numerous sectors could be exposed to heightened credit risk' if the developer was to default. Several other property developers have been pulled down as well, trapped by the gravity of Evergrande's problems, triggering fears of contagion throughout the sector. Traders have been unable to buy or sell Evergrande shares after trading in them was suspended on 4 October.

Economic structural change

The rapid journey to becoming the second largest economy has been driven by enormous investment by central government in infrastructure and embracing technology. At the beginning of this journey China relied heavily on a large and underused workforce helping to keep labour costs competitive. Demographically China has challenges which in large part are self-inflicted. In 1979, along with economic reform the government introduced the 'one child policy' which has had a dramatic impact on the size of the available workforce.

According to a McKinsey Global Institute study, China's fertility rate fell from about 5.8 births per woman in 1964 to 1.6 in 2012. According to the Chinese Government, the size of its working age population (ages 16 to 59) peaked at 925 million in 2011, but then fell for seven consecutive years to 897 million in 2018. The Chinese Government projects that its working age population will drop to 830 million by 2030 and to 700 million by 2050. If these projections prove accurate, the Chinese working age population could drop by 225 million individuals (2011-2050).

The implications mean their economy will likely have to adapt to overcome this demographic challenge but also evolve the growth engine from central government investment into a more modern economy driven by consumers and services. The potential clash between the economic challenge and the political beliefs and values the government want to pursue will potentially make this evolution difficult to navigate without impacting on the confidence and desire of international investors to want to share this journey. China still represents fantastic investment and trade opportunities for investors providing they accept that the goalposts and rules of the game can be changed without consultation or notice. Many investors see this as a risk worth taking, but for some this risk is beyond their comfort zone.

Find out more!

Listen **here** to our latest Market Views from Stefano Amato, Head of Multi-Asset Solutions UK, as he shares his thoughts on the main themes dominating markets.

Note: Data as at 20 October 2021.

Important Information