FUND LAUNCHED
2005

FUNDS UNDER MANAGEMENT
£554.4
MILLION

NET ASSET VALUE PER SHARE
395.5%
SINCE INCEPTION*

UTILICO
Emerging Markets Trust plc

China: is the post-pandemic growth story nearing its end?

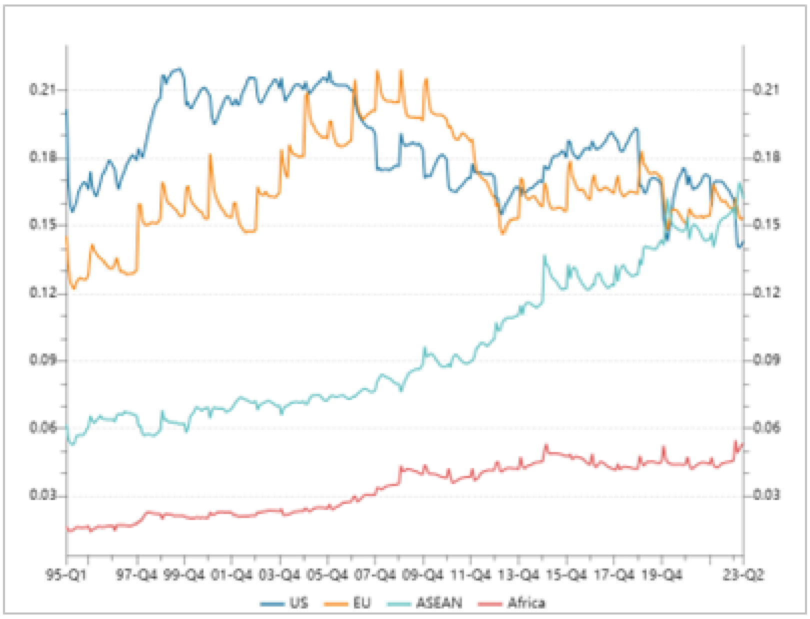
June 2023

Having endured some of the harshest lockdowns during the pandemic, China surprisingly pivoted away from its zero covid policy in January 2023. This unleashed enormous pent-up demand, evidenced by an economic rebound in Q1 with GDP growth at 4.5%.[(1)] However, growth momentum has subsequently softened, prompting concerns about the longevity of China's growth story.

An uneven recovery?
While historically China's approach to policy stimulus has been widely accommodative, we believe that this is now changing from "quantity" to "quality", even if this means accepting a slower growth pace and an uneven recovery pattern, specifically:

- May's manufacturing PMI contracted for the second month,[(2)] whilst the domestic service sector sustained expansionary momentum.
- Exports flourished in Jan-Apr due to a backlog of orders, however this cooled in May[(3)] as demand from Europe and US has tapered off. This contrasts with growing export value to ASEAN countries, with which total trade nudging up +9.9% in Jan-May.[(4)]
- Profits at State Owned Enterprises ("SOEs") grew robustly by +15.1% Y-o-Y for Jan-Apr whereas private-sector firms saw a -22.5%[(5)] fall.

China Export Value as % of total value by region



Source: Wind

Prudent and targeted stimulus

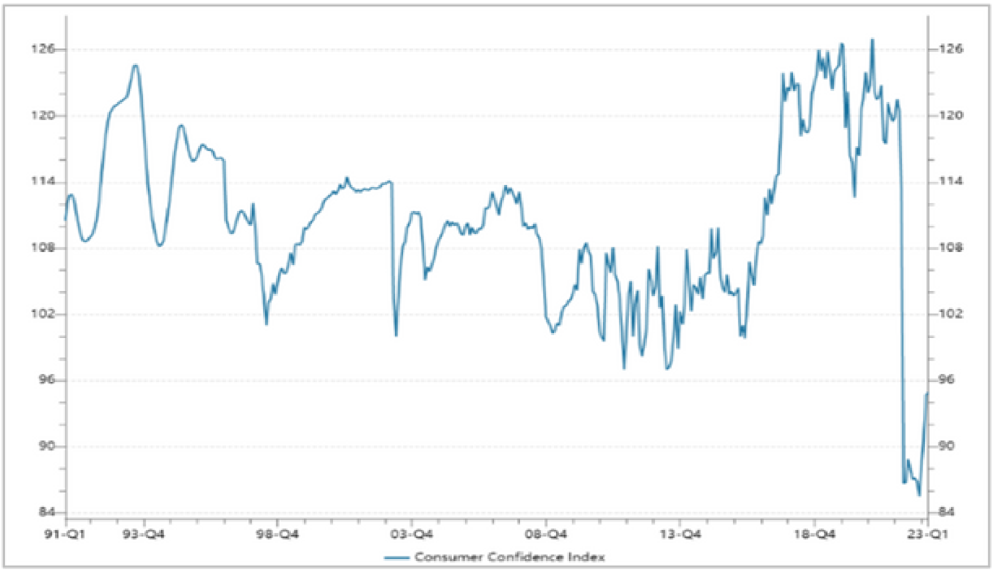
The question remains whether Beijing will implement more stimulus in 2H23 to invigorate the economy. In our view, the PBoC will maintain accommodative policy (evidenced by the recent 10 bps[(6)] rate cut for the benchmark lending rate), but an all-out stimulus seems unlikely given 1) the 5% growth target appears achievable thanks to the low base effects from last year; and 2) PBoC has signalled the importance of adopting a "prudently easing" approach as opposed to an overly aggressive one which may cause problems in future.[(7)] As such, we anticipate the PBoC will continue to pursue quality over quantity, with additional focus in certain areas like renewables and technological innovation to revive the private economy.

Consumer confidence still fragile

The immediate challenge for domestic consumption is deficient demand due to weak consumer confidence, with a precautionary saving mentality currently prevailing. There is a glimmer of hope in that the overall urban unemployment rate dropped to 5.2% in May, tightening from 5.7% in November 2022[(8)] driven by the return of migrant workers. This should bolster consumer confidence which has already started rallying from its historic lows.

A significant concern, however, is that youth unemployment hit a record high of 20.8%[(9)] in May. This will compel the Chinese government to step up pro-employment policies at some point. Measures such as the very recent deposit rate cut of 10-15bps[(10)] are anticipated to spur consumption further, and future stimulus might also take the form of consumption vouchers. It is notable that China's consumption as a percentage of GDP is just 38% compared to 68% in US and 64% in UK.[(11)] With approximately 610 million people (44% of total population) still earning less than RMB1,000 (US$143) per month,[(12)] the long-term potential for domestic consumption still remain significant.

Consumer Confidence Index

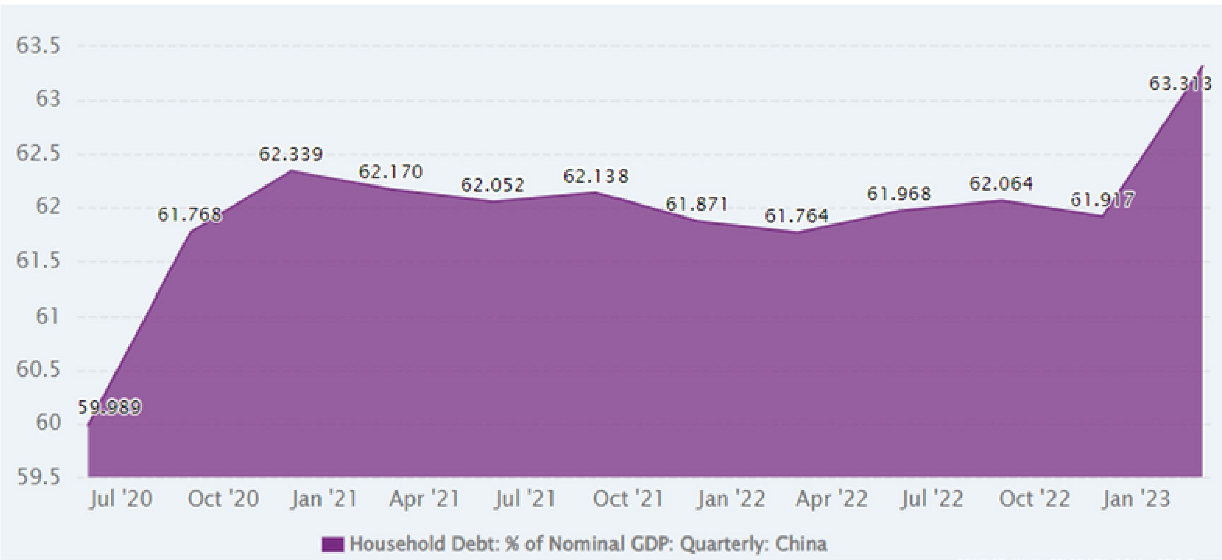


Source: Wind

Real estate market subdued

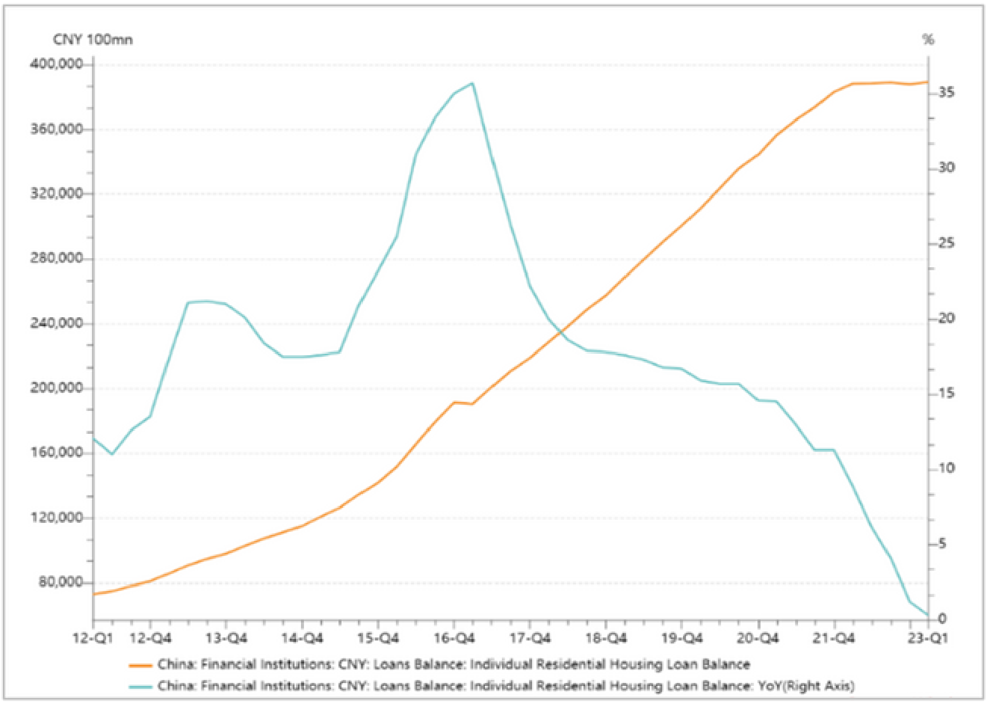
Despite easing curbs on home purchases, the property market in China remains lacklustre with many homeowners opting to repay mortgages instead of investing in new properties. Compared with developed counterparts which are more yield-focused, Chinese property investors have historically bet on capital gains over rental yields which are typically very low. However, as Chinese households came out of Covid with a higher leverage,[13] and interest rate cuts have lowered deposit rates more than borrowing costs, confidence in the property market has fallen. With limited scope for price appreciation, homeowners have looked to repay debt early. As such, recent measures by the government to lower the downpayment ratio and mortgage rates have had a very limited impact on the wider property market.

Household Debt



Source: CEIC Data

China: Financial Institutions Loans Balance



Source: Wind

In the longer term, a meaningful recovery requires improved household finances and confidence. The attractiveness of Chinese real estate assets remains intact due to strict capital control and lack of alternative investment tools. The potential reform of the Hukou system to allow migrant workers to buy urban property could be a significant catalyst. Whether such reforms can offset the pressures of an aging population and an increasingly saturated urbanisation rate, is yet to be seen.

Easing geopolitical tensions in the face of global economic slowdown

China has recently softened its ‘wolf warrior’ diplomacy policy, signalling rising pragmatism in China’s approach to foreign relations. Taiwan remains a critical issue, and improvement of the bilateral relationship will remain top on the agenda for the three candidates vying for Taiwan’s 2024 presidential election. While we do not foresee military confrontation any time soon, the possibility of accidental conflict in the Taiwan Strait cannot be ruled out.

In terms of China’s relationship with US, trade disputes and US restrictions on advanced technology will inevitably hamper China’s economic development. That said, as the Fed continues to battle inflationary pressure in US, we believe economic pragmatism will still dominate at least in the near term and the possibility of complete ‘de-coupling’ is remote. While there will be inevitable tensions in the US-China relationship it’s pleasing to see both sides are determined to deepen communications, evidenced by Blinken’s recent visit to China which aimed at stabilising ties with China.[14]

Outlook for Chinese equity

Our experience in China is that the true socioeconomic impact of any major topic is far more nuanced than headlines suggest. For instance, despite the seemingly irreversible trend of an aging population, we note that China has some of the world's youngest retirement ages - 60 for men and 55 for women in white-collar roles, reducing further to 50 for blue-collar female workers.[15] Meanwhile, the proportion of individuals aged 15-24 in education has soared from 35% in 2012 to 59% in 2022, deferring the entry of 35 million better-educated youngsters into the workforce, creating potential future productivity gains.[16] That said, it is clear that the market is currently skewed towards the negatives, due to geopolitical tensions and lacklustre economic data.

UEM maintains a favourable long-term view of China, with a stable political framework, high liquidity and some excellent individual investment opportunities. However, we also recognise the challenging backdrop, hence UEM's positions in China are highly selective with approximately 15% exposure consisting mainly of SOEs that are aligned with the government agenda, provide decent dividend payouts, and are well placed to capture the recovery gains e.g. Shanghai International Airport, Citic Telecom and China Datang Renewable Power, etc. The recovery in China is uncertain and may be protracted, therefore for us a selective bottom-up investment approach remains key to delivering returns in this challenging market.

Gillian Zhao
26 June, 2023

Source Data: ICM Limited as of 20 June, 2023.

[1] National Bureau of Statistics of China. Retrieved from https://data.stats.gov.cn/english/easyquery.htm?cn=B01
[2] National Bureau of Statistics of China. Retrieved from http://www.stats.gov.cn/english/PressRelease/202303/t20230301_1920496.html
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[15] World Economic Forum, 3 May 2022. Retrieved from https://www.weforum.org/agenda/2022/05/china-change-retirement-age/
[16] CLSA China Reality Research,23 May 2023. Demographic dividend to dilemma.

*Total return is calculated based on undiluted Net Asset Value, plus dividends reinvested and adjusted for the exercise of warrants and subscription shares

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