GavekalDragonomics

May 2023

China Economic and Geopolitical Outlook

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Agenda

- Economy in 2023
- Long-term growth prospects
- Political and geopolitical developments
- Balance sheet: China's "investibility"

The economy: Decent recovery well underway

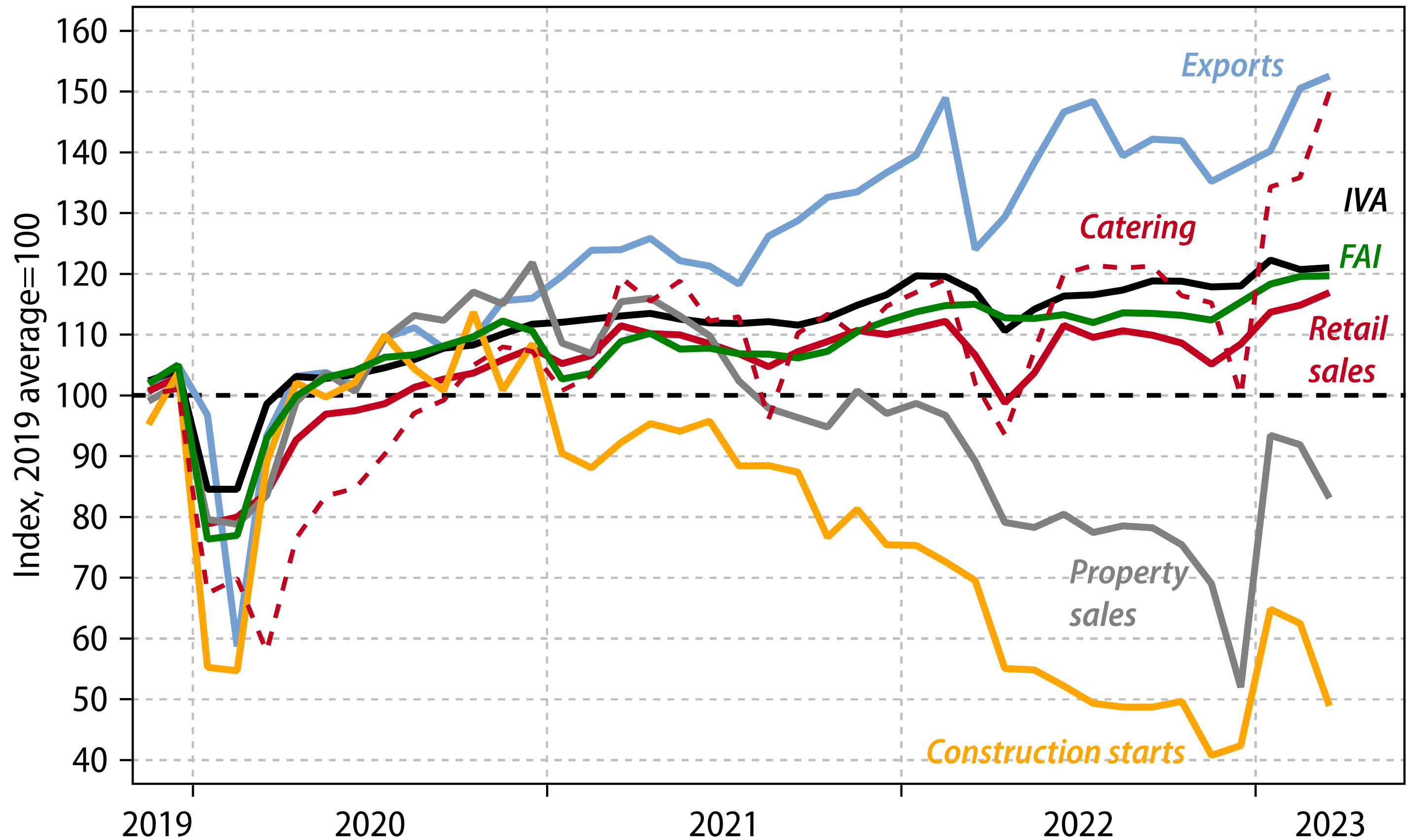
- Q1 data indicate that a broad-based recovery is well underway, led by property and consumption. GDP growth accelerated to 4.5% in Q1 from 3.0% in Q4 2022. Target growth of "around 5%" will be met.
- Inflationary pressure will be modest thanks to structural overcapacity and less extra household income than in the US.
- Not much extra boost from fiscal/monetary stimulus, but private-sector credit acceleration is bullish for equities.

Key indicators (Yoy % ch)	Dec 2022	Jan-Feb 2023	Mar 2023
Fixed-asset investment	3.1%	**5.5%**	**4.7%**
Industrial value-added	1.3%	**2.4%**	**3.9%**
Retail sales	-1.8%	**3.5%**	**10.6%**
Exports (RMB terms)	-0.5%	**0.9%**	**23.0%**
Property sales	-32%	**-3.6%**	**0.1%**
Construction starts	-44%	**-9.4%**	**-29.0%**
Private sector credit	8.9% (Jan)	**9.3%** (Feb)	**9.6%**

Recovery is broad-based; property is the biggest variable

Retail and property sectors rebounded in January and February

Monthly economic indicators, seasonally adjusted levels



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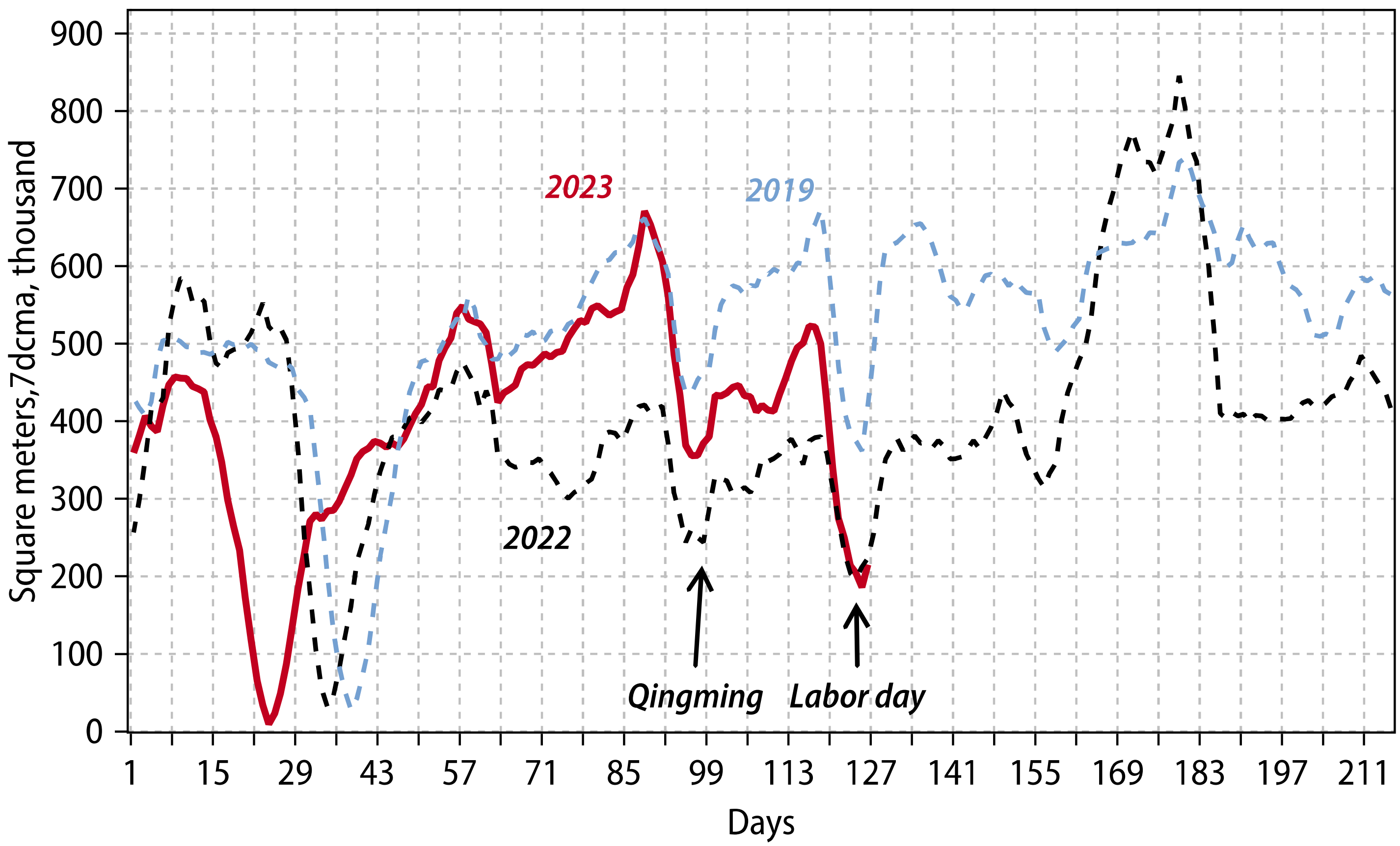
Q1 property sales were at pre-pandemic levels; weaker since then

Property sales have softened since March

Daily property sales in 30 major cities since the first day of the calendar year



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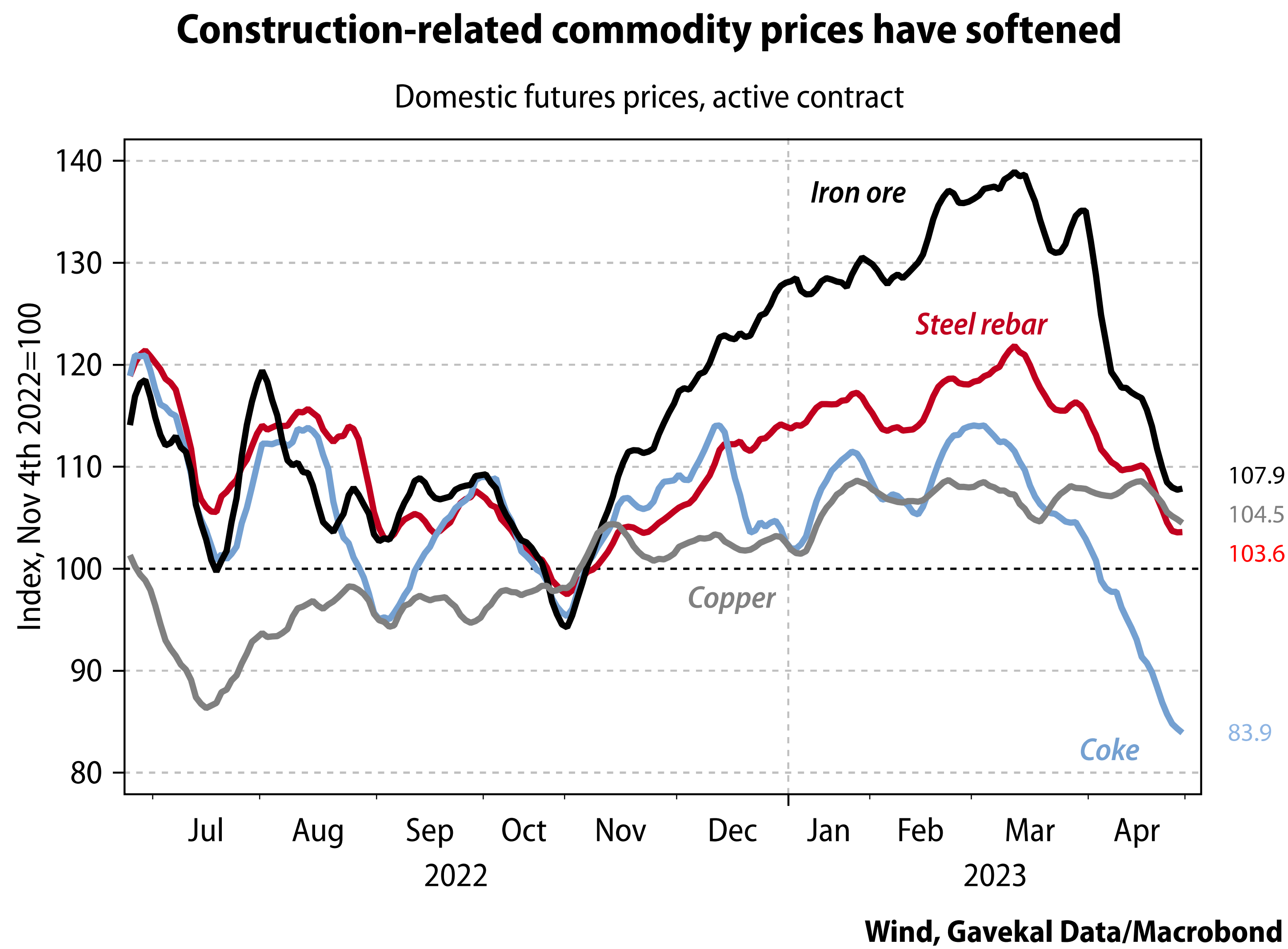
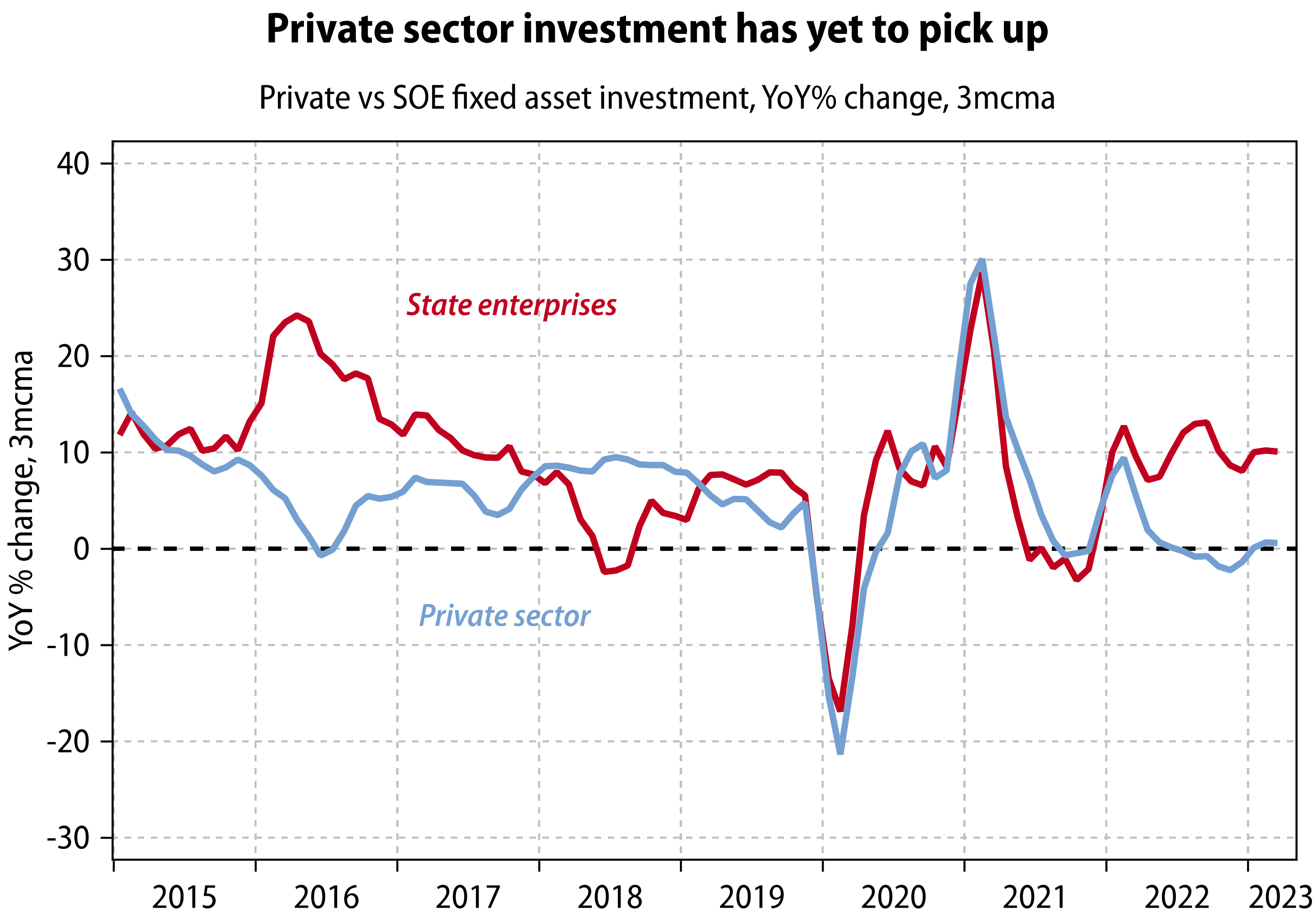
Metals prices have weakened with the property slowdown



Private investment is still a soft spot…



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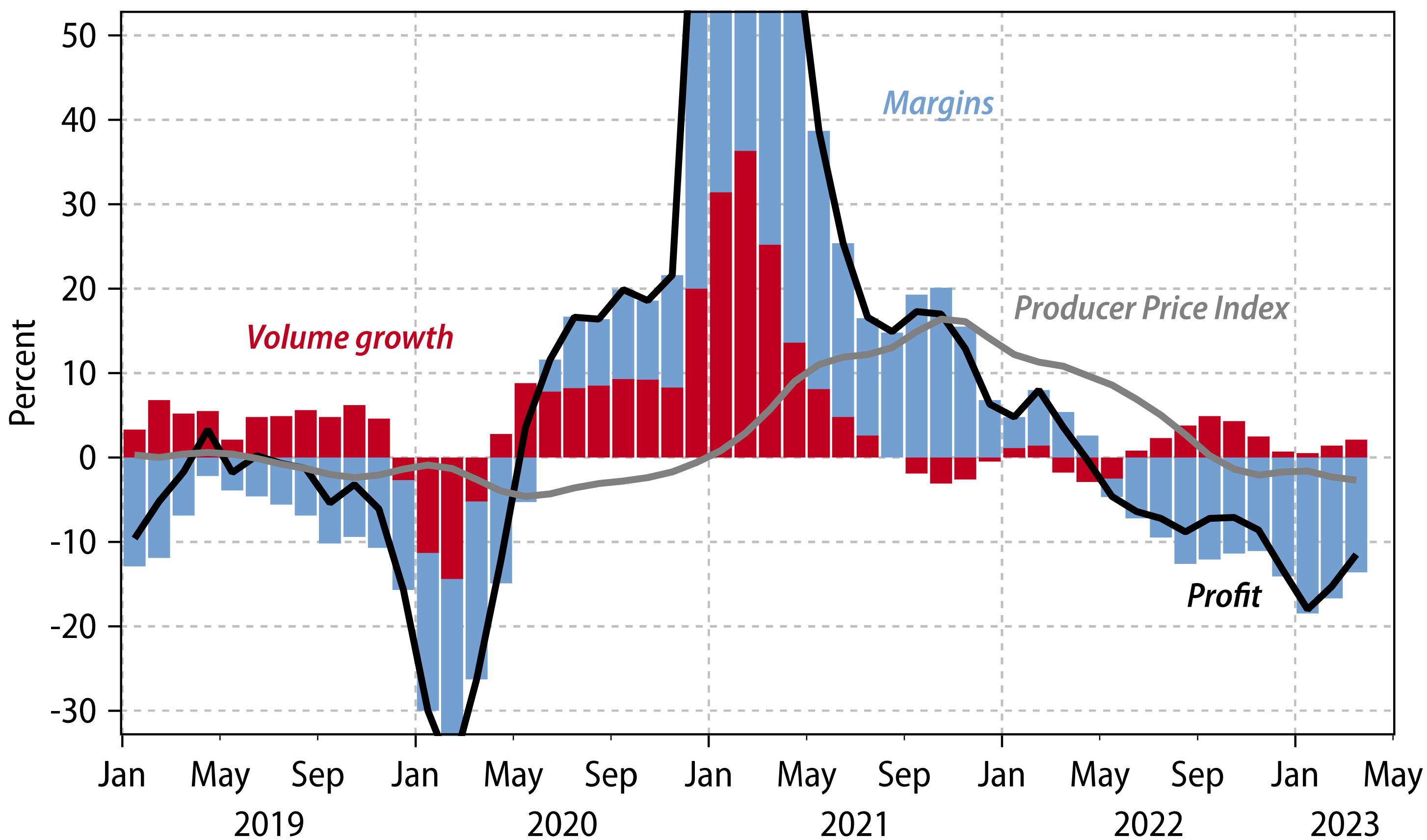
. . . but industrial profits are likely to pick up

Industrial profits are near the nadir of the cycle

Components of % annual growth in industrial profits



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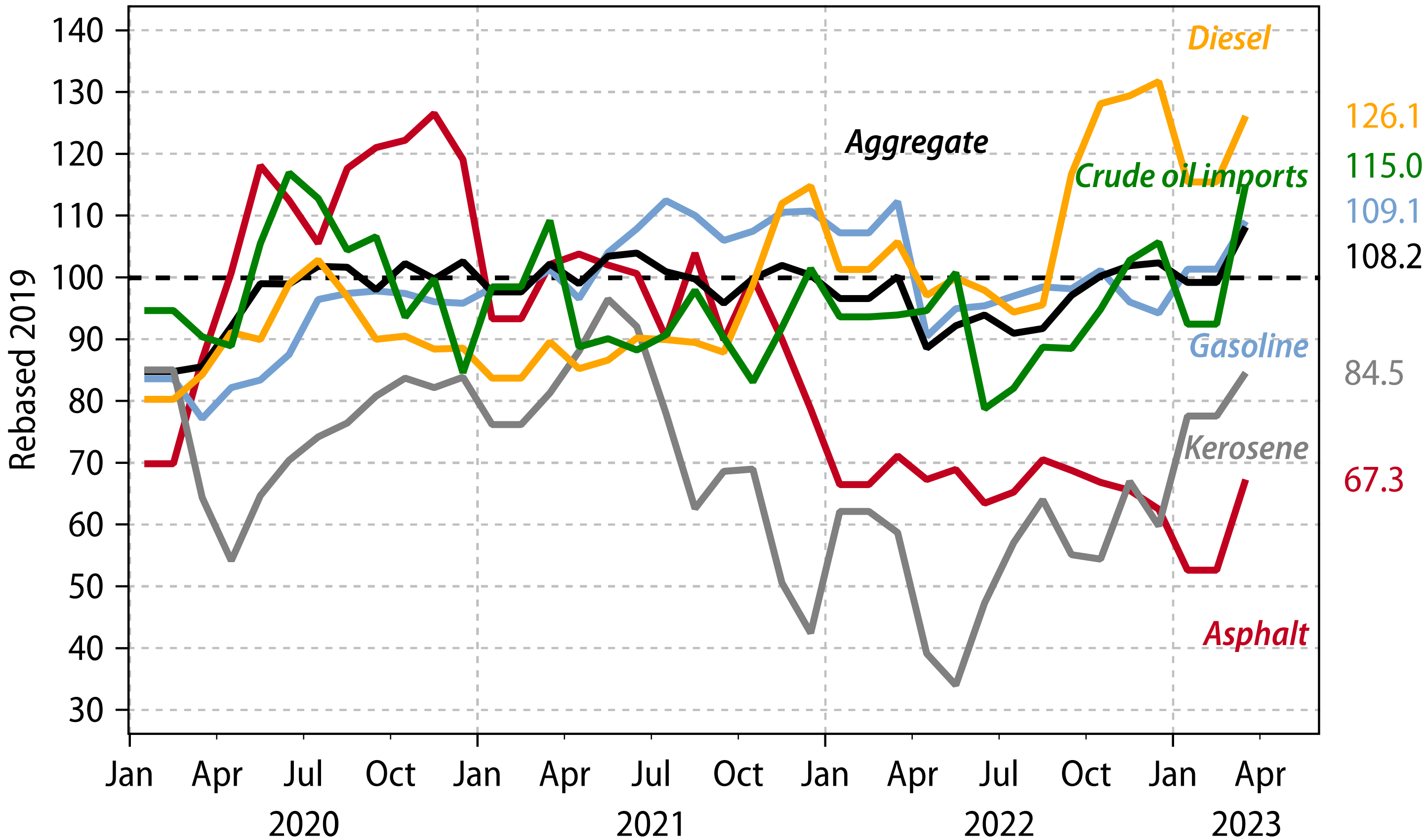
Oil demand is a positive signal

Chinese oil demand is picking up

Petroleum product output by major category, rebased to Dec 2019



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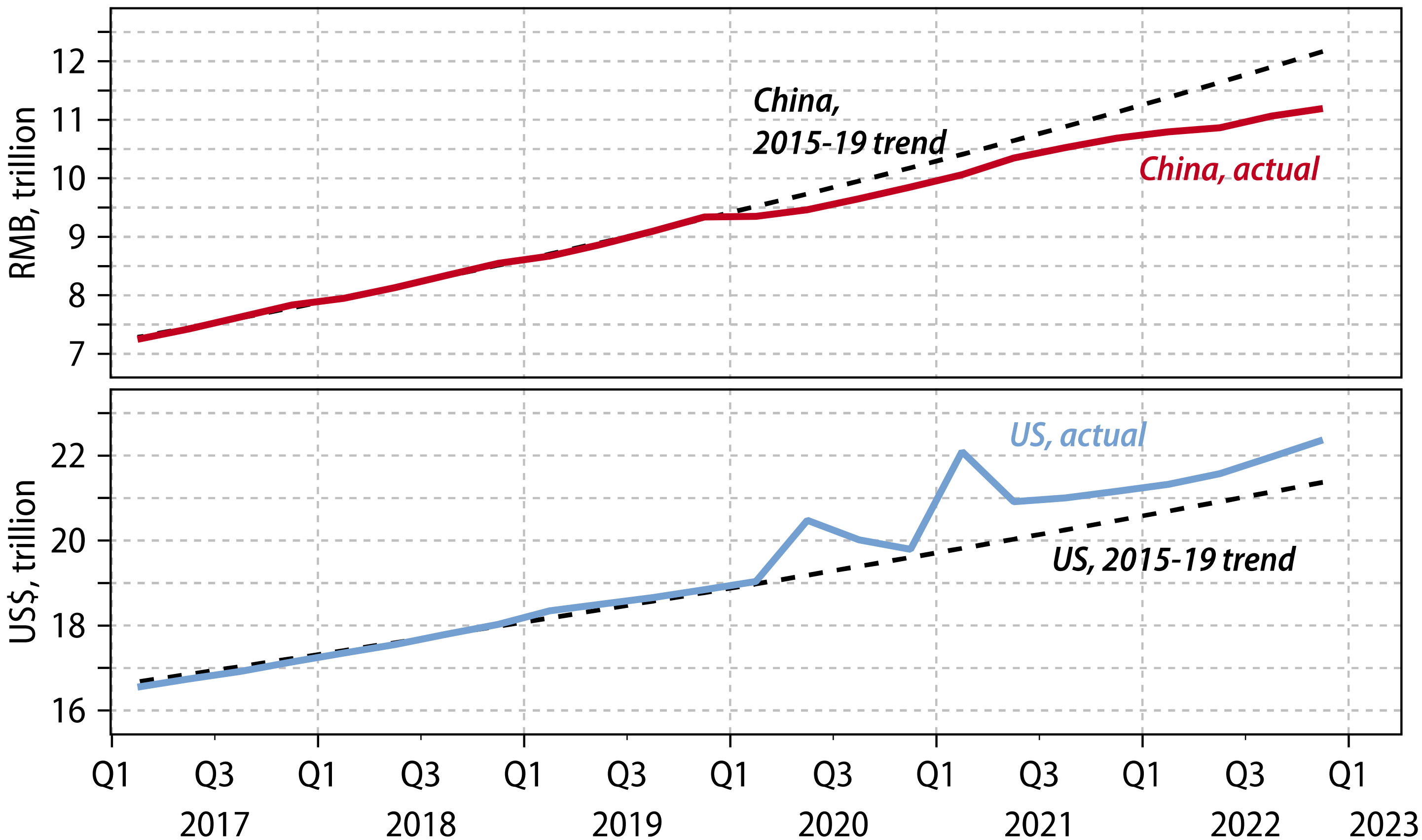
Inflationary pressure is less than in the US

China's household income is below trend, the US's is above trend

Total household income, actual and pre-Covid trend, US (saar) vs China (1yma)



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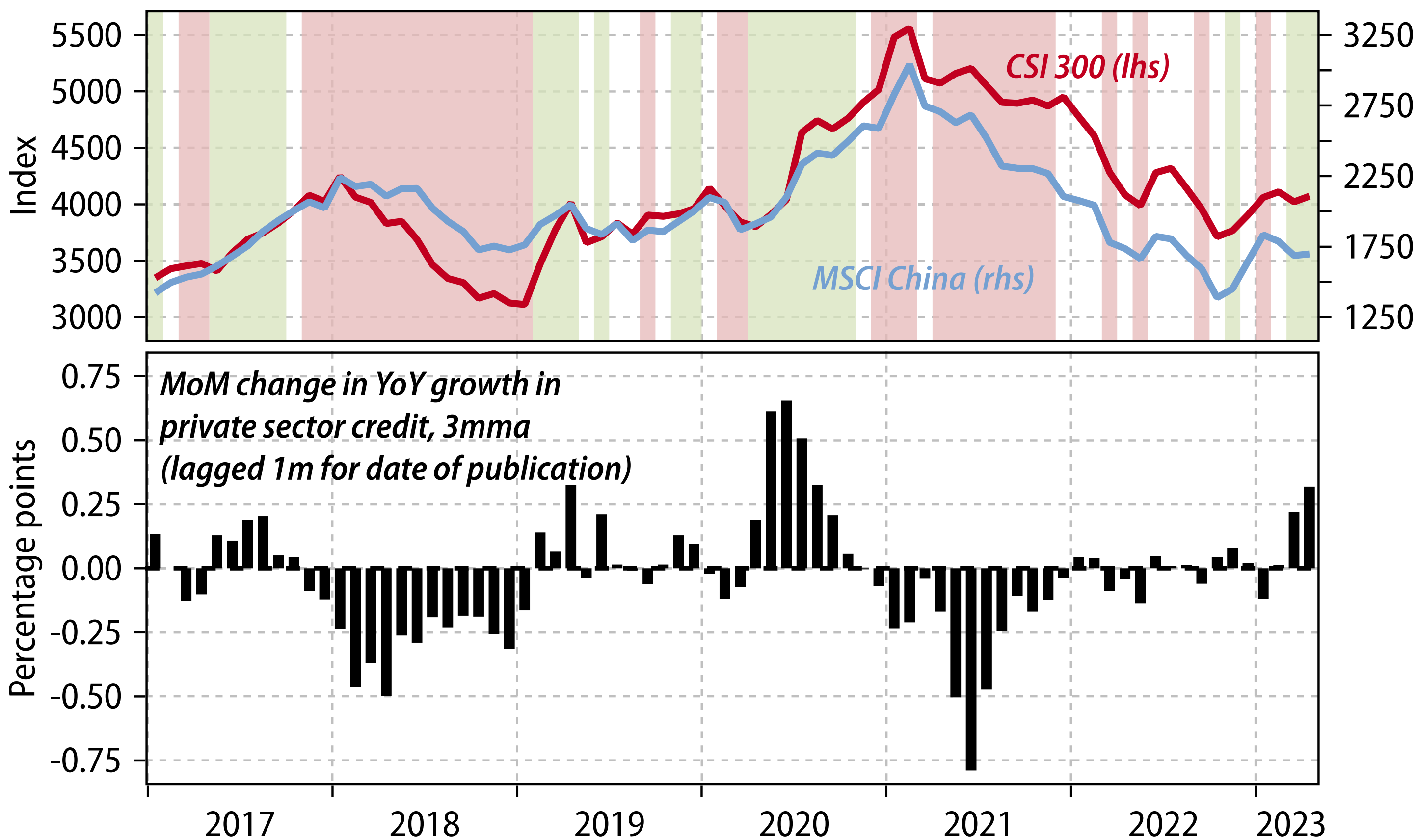
Accelerating credit growth may be good for equities…

Feb-Mar credit data sent the strongest buy signal since 2020

Pink = decelerating credit, green = accelerating credit, white = zero +/- 0.05%



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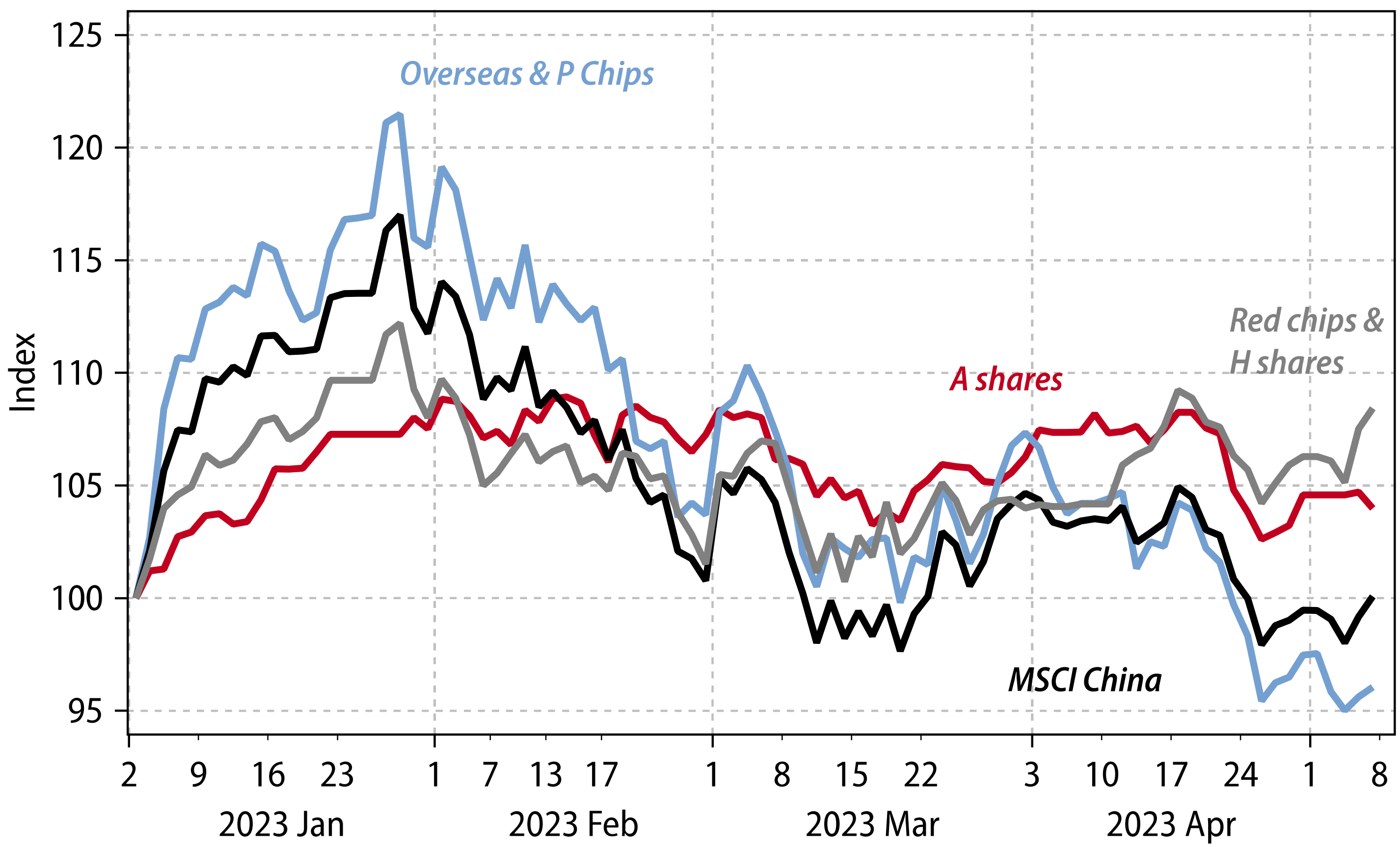
. . . but markets are still languid

Markets took another leg down in recent days

Components of MSCI China, indexed to 1 Jan 2023



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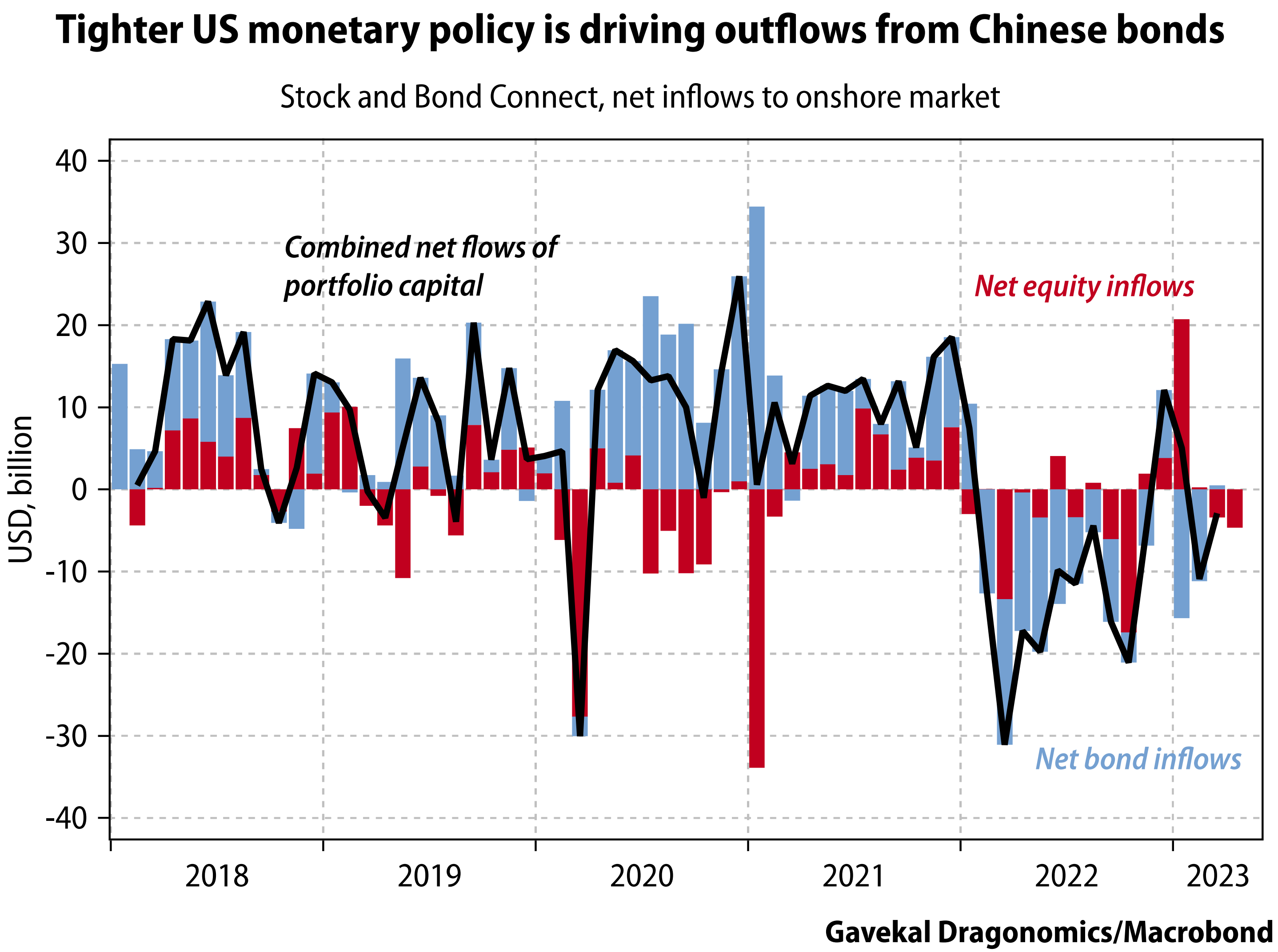
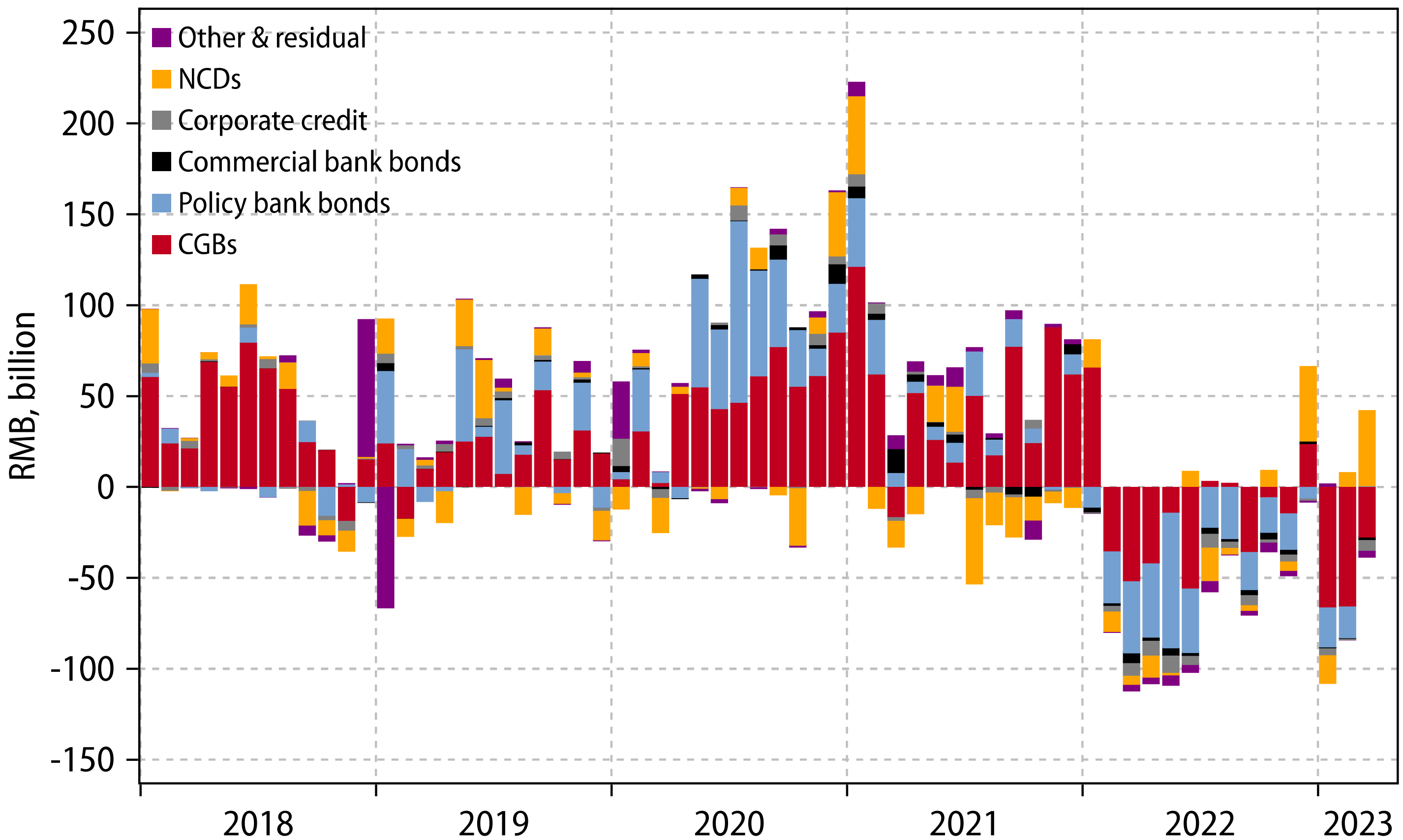
Foreign investor enthusiasm has vanished



Net bond outflows are especially notable

Outflows from Chinese bonds continue at a strong pace

Monthly change in foreign bond holdings, by bond type



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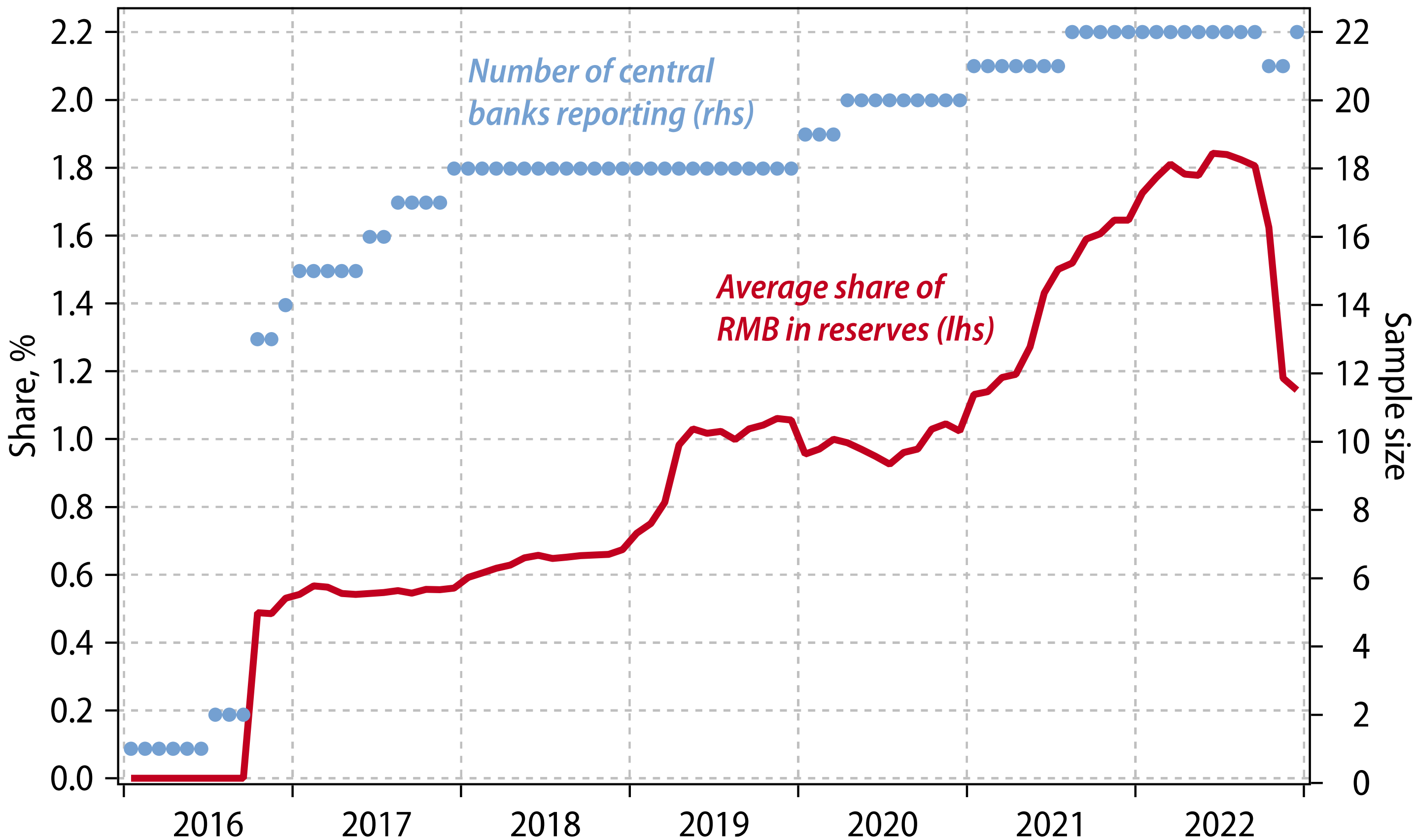
Central banks are retreating from CGBs

Direct reporting also shows central banks trimming renminbi bonds

Central bank holdings of renminbi assets, IMF IRFCL disclosures



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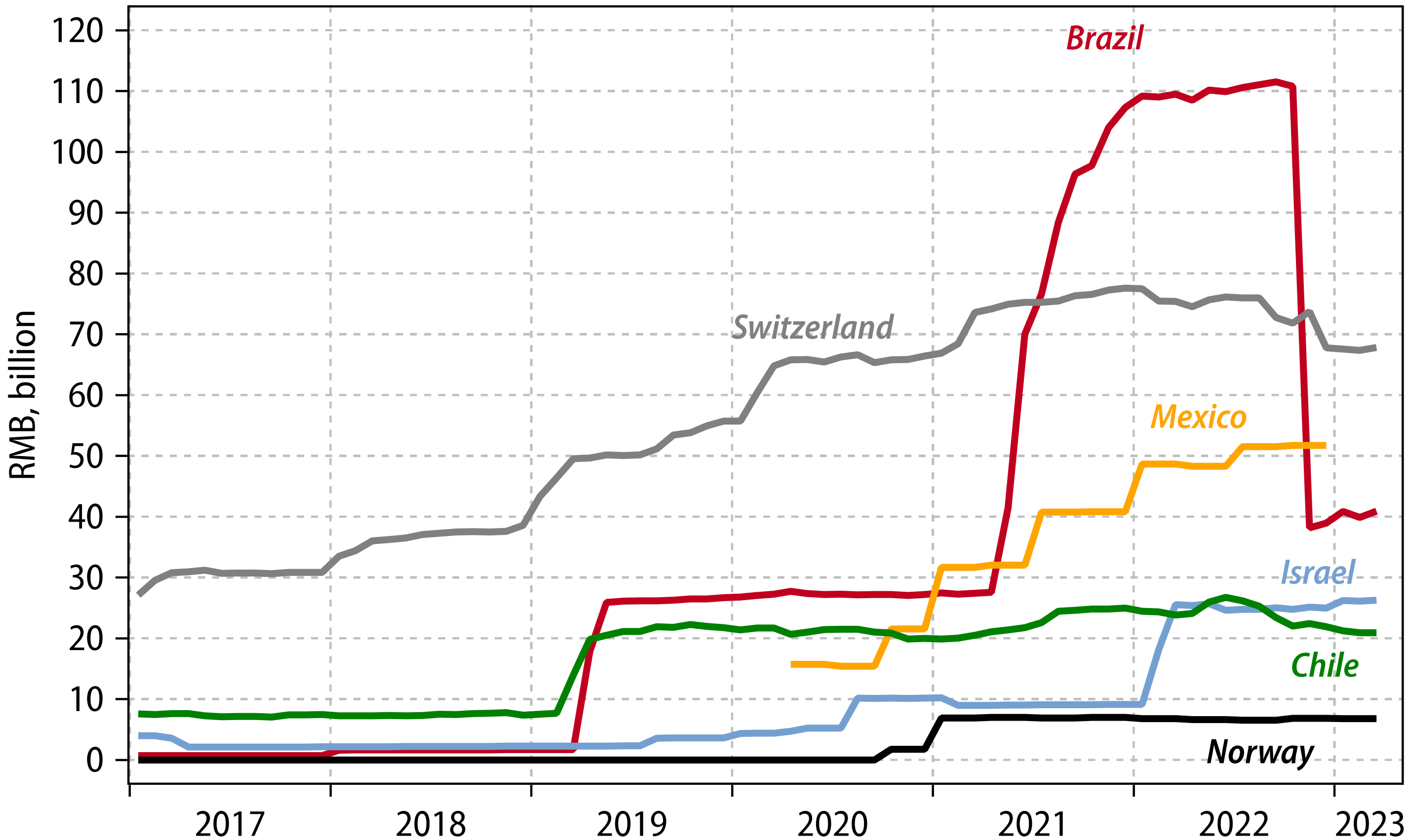
Brazil's shift is the most noteworthy

Brazil's position has changed most dramatically

Central bank reserves held in renminbi, by country



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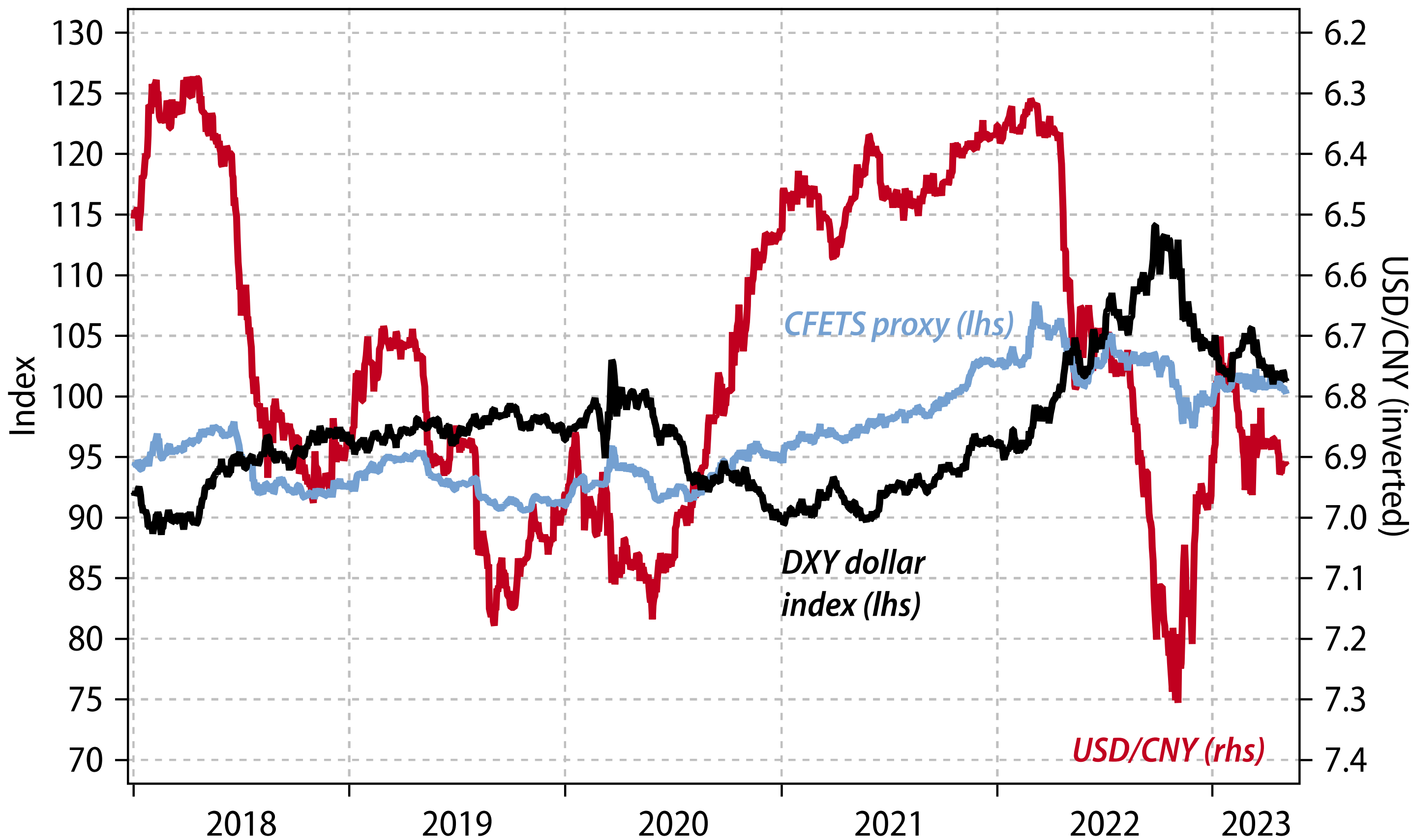
Renminbi is now range-trading

End of the dollar rally takes pressure off the RMB

Remminbi/dollar spot rate vs trade-weighted RMB and dollar indices



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Long-term growth prospects

Negatives:

- Demographics are inexorably worsening
- The long property boom is over and a multi-year adjustment has started
- Capital spending relies too much on low-return infrastructure and not enough on high-productivity business investment
- High financial leverage is a binding constraint

Positives:

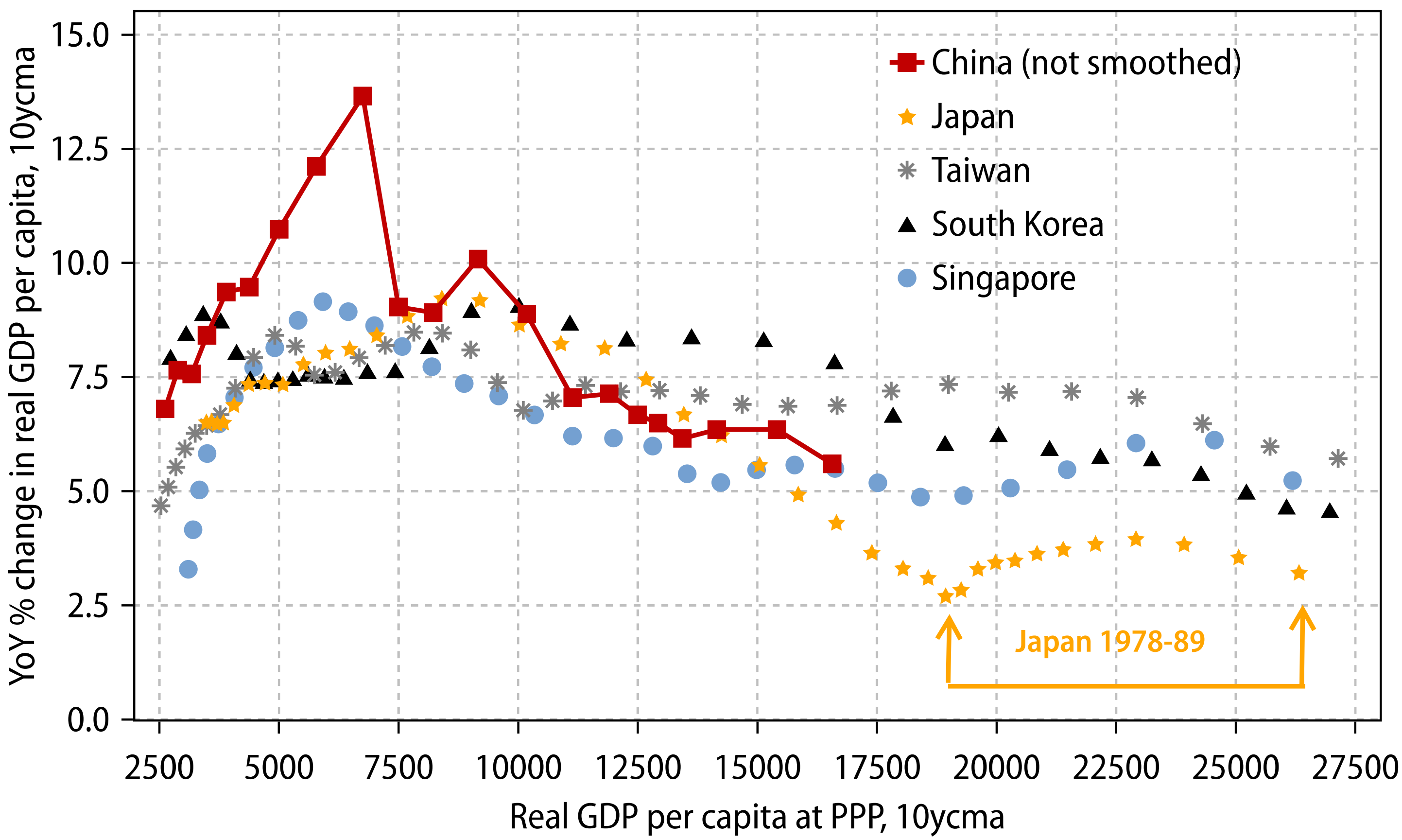
- Catch-up growth is not over; technological progress is evidently rapid
- Urbanization will slow, but will continue to create large numbers of new high-income consumers
- Ability of government to mobilize/catalyze investments in new industries

Bottom line: Over the next decade China's trend annual growth could be as high as 5% (only with strong competition/finance reforms) or as low as ~2% (with no reforms).

Future growth, and its constraints

As China gets richer its growth will keep slowing

Trend growth rates and level of development for successful Asian economies



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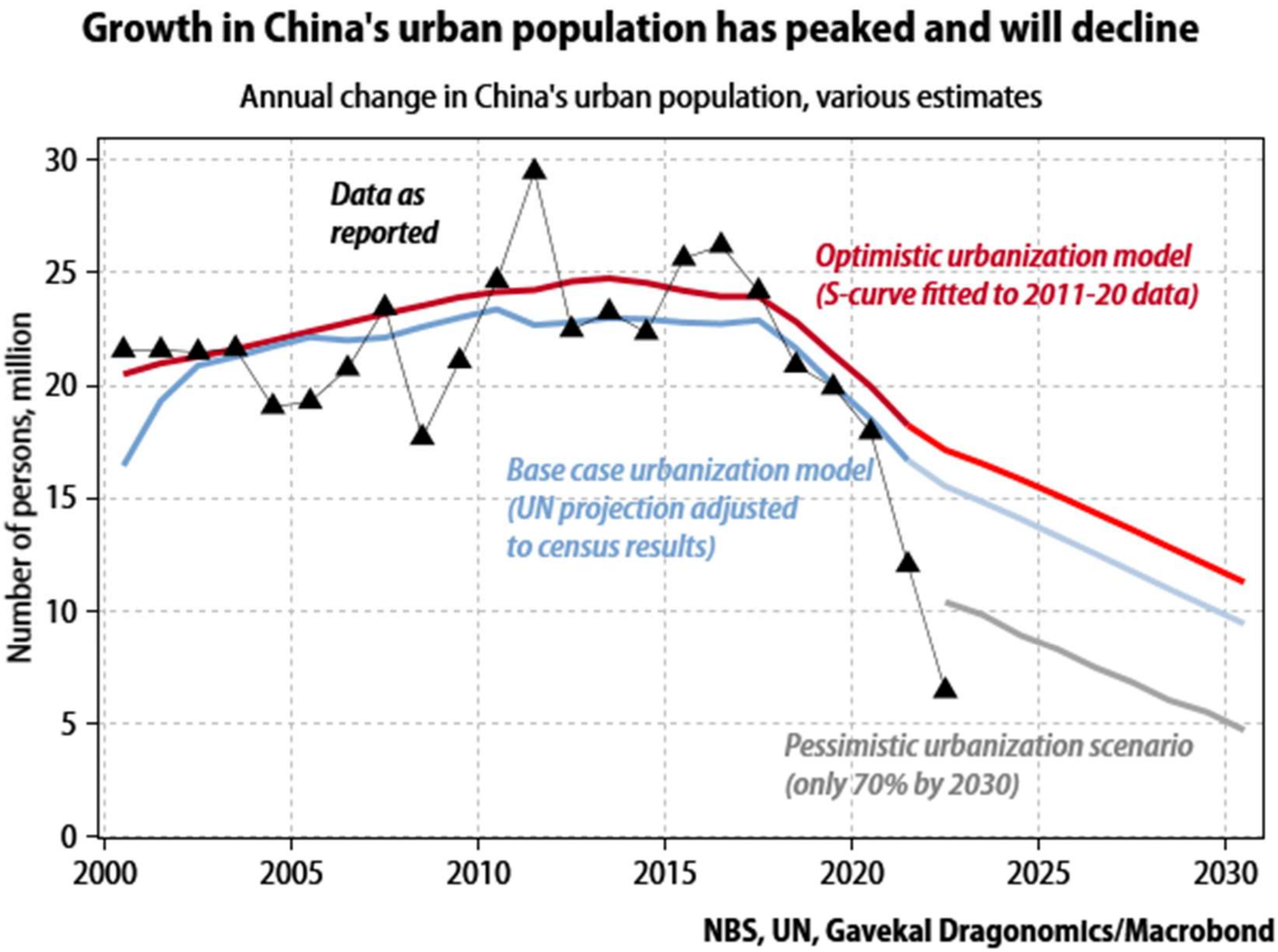
Constraint 1: Urbanization isn't over, but the housing boom is



Projected change in annual housing construction, 2019-2030:

Optimistic: -20%

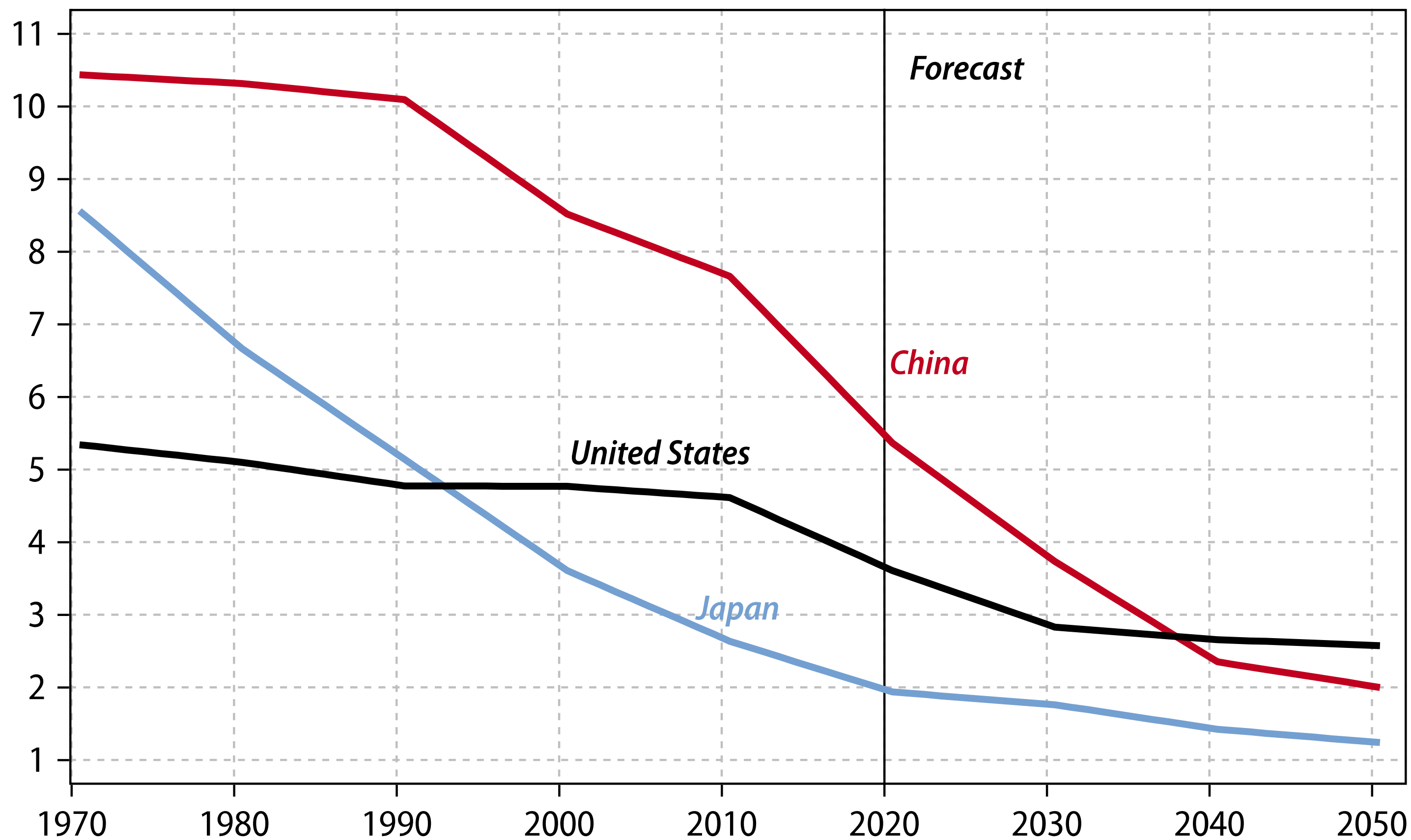
Base: -24%

Pessimistic: -35%

Constraint 2: An aging society

China's worker-retiree ratio is heading towards Japan's

Ratio of working age population (15-64) to retirees (65+)

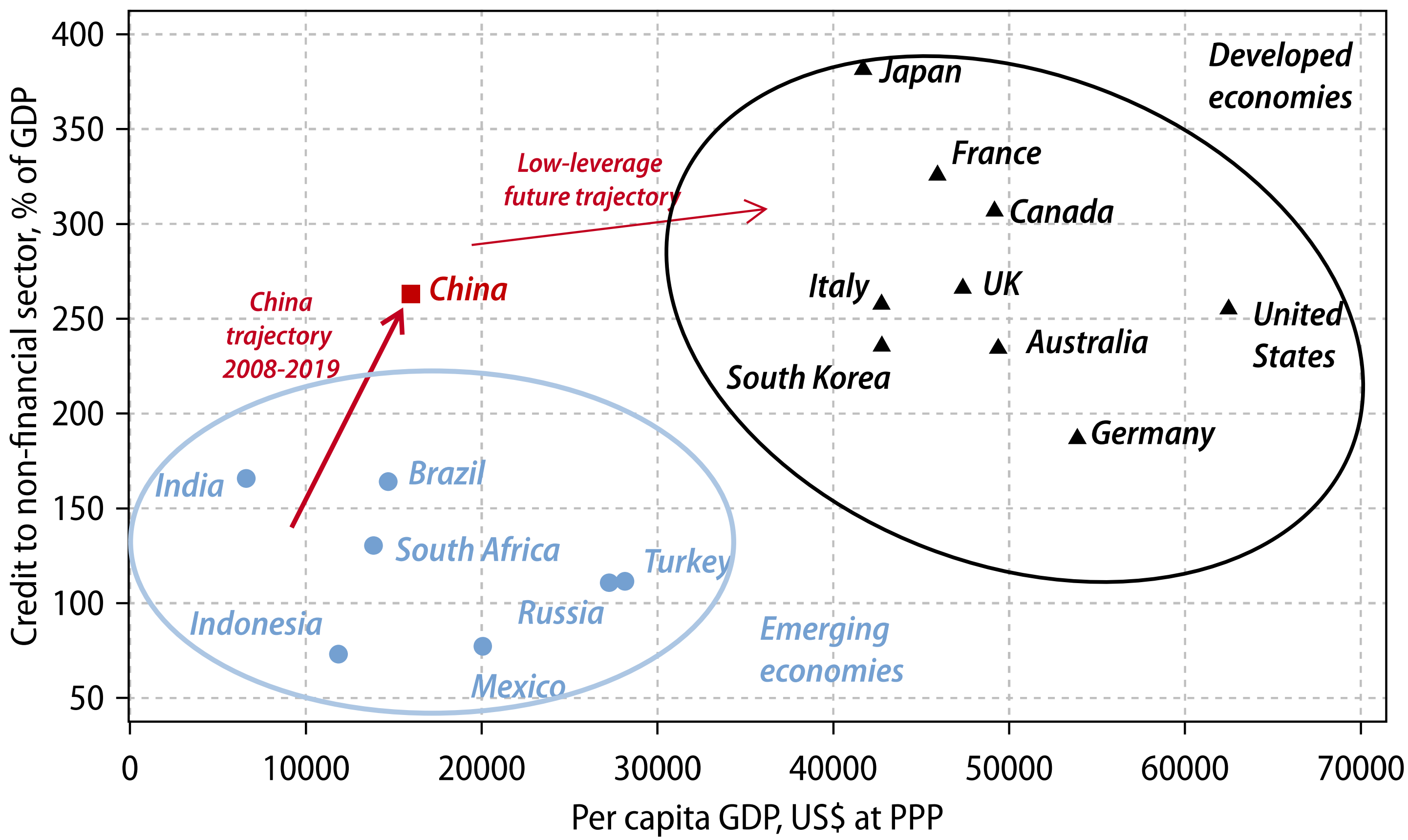


UN Population Prospects

Constraint 3: Debt

China's debt is high for its level of income

Non-financial debt, % of GDP, vs GDP per capita at PPP (2019)



World Bank, BIS, Gavekal Dragonomics/Macrobond

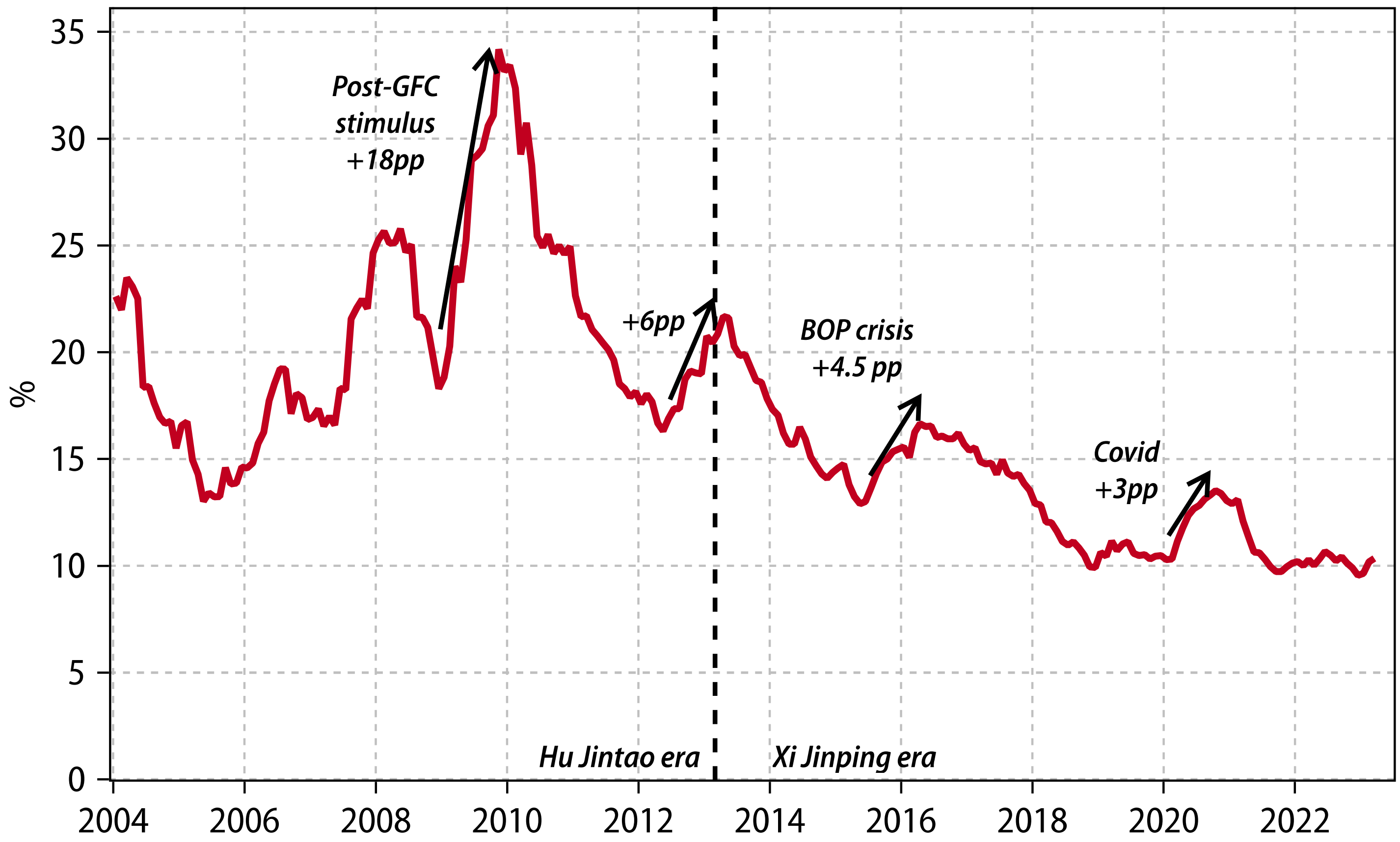
China' gross debt/GDP is similar to that of many developed economies.

China's debt level is high relative to other major emerging markets

Credit restraint is now a permanent feature of macro management

China's credit cycles

YoY growth in total credit stock, %



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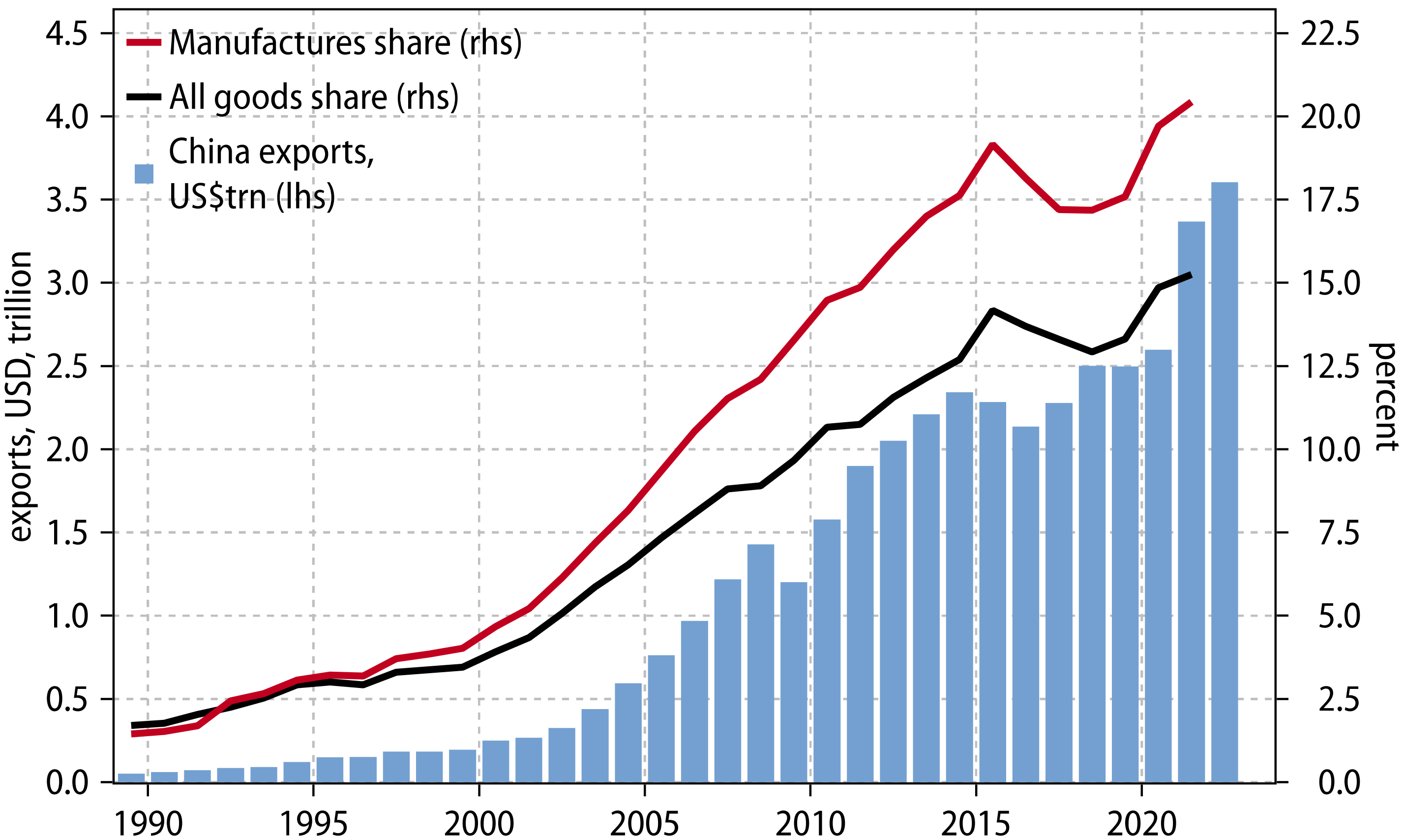
The bright spot: Exports point to technological gains

China keeps gaining global export market share

China's % share of world exports, annual



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China's exports are slowing cyclically.

But structurally, China continues to pick up global share and it now accounts for about 20% of global exports of manufactures.

Moreover, a growing share of these exports come from domestic export champions, rather than foreign enterprises. This suggests that domestic firms are improving their technological level.

FIE share of China exports

2005	58%
2010	55%
2015	45%
2021	35%

Xi Jinping's wishlist: A better regulated state, a more powerful China

- **China governance:** A disciplined, well-regulated state with modernized institutions, supervised by the Communist Party of China:
  - **"Rule of law":** more well-defined laws and regulations, more strictly enforced.
  - **"Common prosperity":** More equal income distribution, support for families, traditional morality, paternalistic state.
- **China in the world:** A great power at the center of a global network:
  - **Regional hegemony:** American decline enables China to become the preeminent Asian power; its actions are not constrained by American technological, financial or military power and alliances; China also avoids its own "entangling alliances"
  - **Territorial integrity:** Taiwan reintegrated into the mainland, eventually.
  - **Global influence:** China is the hub of a global network of trade and investment; its model of governance is recognized as the world's most successful.
- **China economy:** A "venture capitalist state" with greater tech self-reliance:
  - **VC state:** State guides and catalyzes investments across technology sectors; most firms are hybrids of private and state ownership.
  - **"Dual circulation":** China largely self-sufficient in key technologies; foreign countries are increasingly dependent on China's market and technology.

Governance shifts after the March 2023 NPC

- The trend continues: decision-making power increasingly concentrated in central CCP bodies answerable to Xi:
    - Central Science and Technology Commission (tech industrial policy)
    - Central Financial Commission (financial policy)
    - Central Financial Work Commission (party-building)
    - Central Social Work Department (party influence in private sector, grassroots)
- Implied policy goals:
    - Stabilize and grow the economy after 3+ years of policy-induced volatility
    - Less emphasis on financial de-risking
    - More centralization of industrial policy and funding
- Explicit aim: "New-style whole-nation system" for developing core technologies

Domestic corporate governance

The higher-growth scenario for China depends on a dynamic entrepreneurial sector. Much policy over the past several years has sought to constrain the private sector:

- Financial de-risking (constrained credit to private sector)
- Crackdown on (largely private) property sector
- Crackdown on internet sector after canceled Ant IPO in Nov 2020
- Increased use of state investments, board control, "golden shares" and party committees to inject state control over private businesses

Does China still have a private sector?

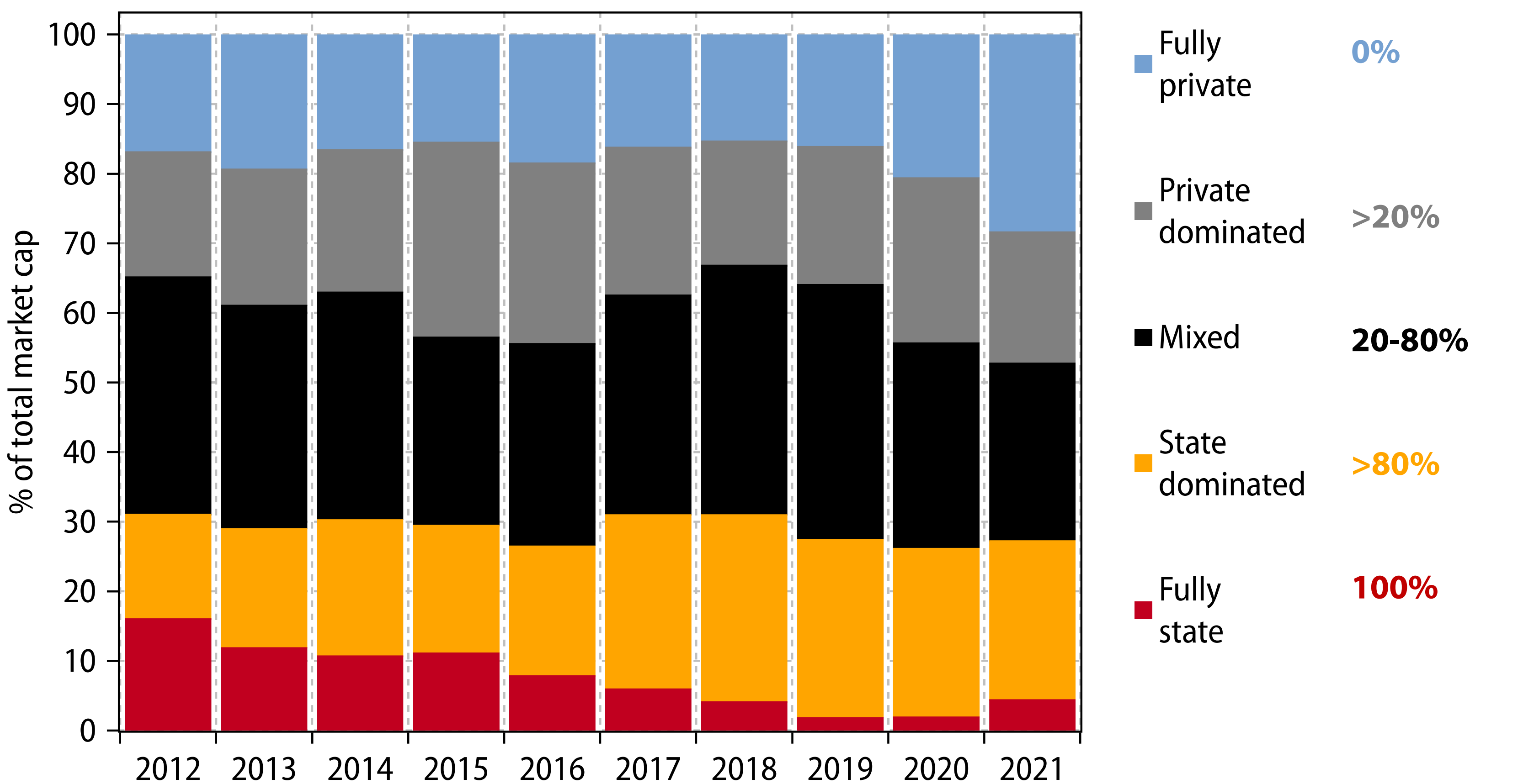
Our answer: Yes, it does.

- Many big successful firms have always been private-state hybrids; state influence grows at the margin but not hurt performance.
- Regulatory efforts are driven more by desire to restrain "gilded age" excesses than to crush private companies.

Does China still have a private sector? Yes

Mixed ownership has usually been the dominant category

Share of onshore market cap, by structure of firms' major shareholders



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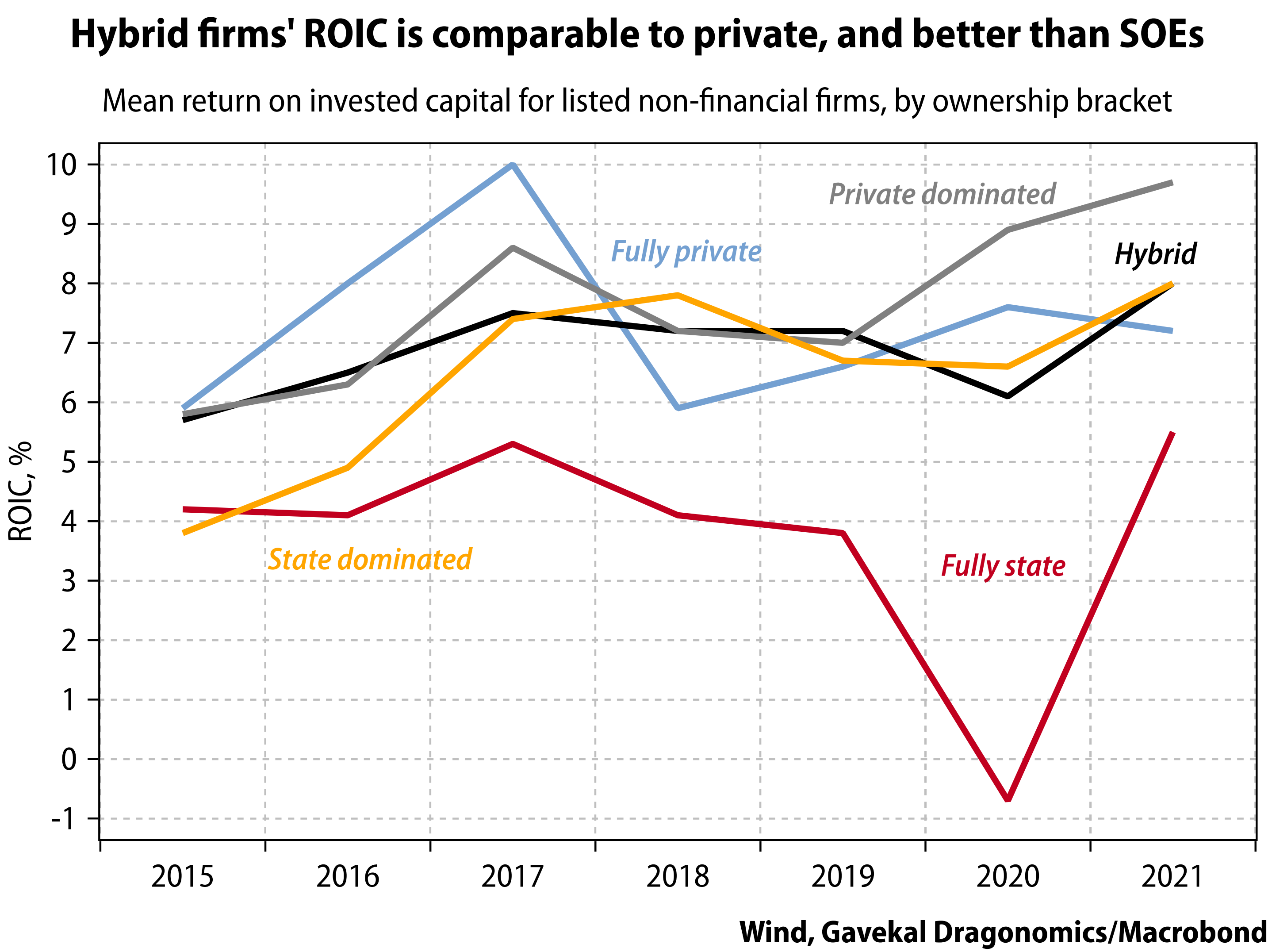
Increased state influence doesn't necessarily destroy returns



Geopolitical grand strategy

- China's broader geopolitical strategy now organized under the master slogan "Global xxxx Initiative" (xxxx = Development, Security, Civilization).
- General aim: Enabling China's emergence as a global power (and eventually regional hegemon) through economic interdependence, largely within the current global system.
- Specific aims:
  - Create a coalition to counter the US-led "China containment" coalition
  - Soften European support for US containment measures
  - Mobilize support among developing countries
- Scorecard:
  - Win: Iran/Saudi deal to restore relations
  - Stalemate: Debt relief for poor countries
  - Undecided: Russia/Ukraine ceasefire

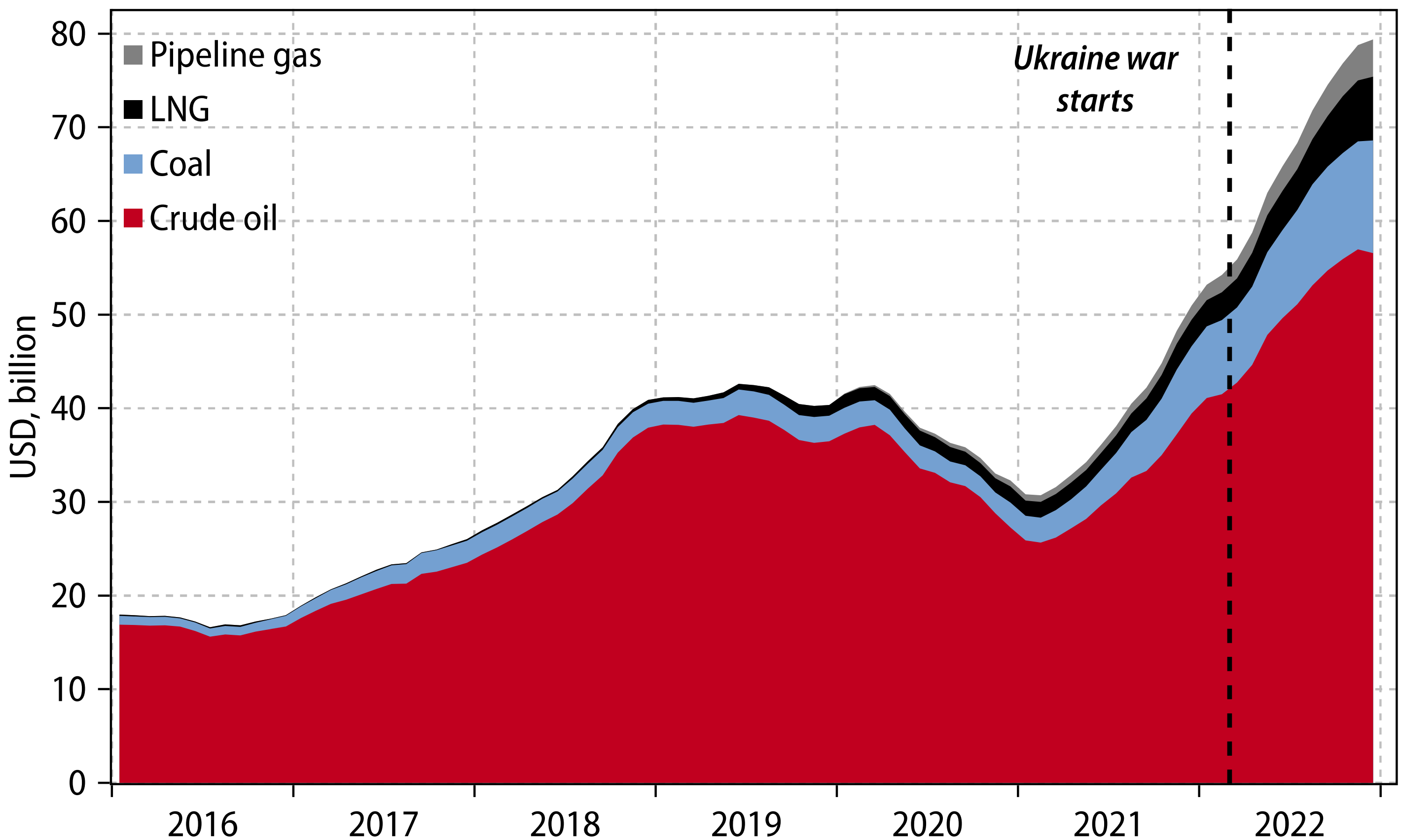
China-Russia: Geopolitical balancing act

- Xi Jinping has made a strategic bet on alignment with Russia.
  - Core beliefs: the US is a) set on containing China and b) in long-term decline.
  - China and Russia share a key interest: creation more space for them in US-led international order; but China wants to sustain the order while Russia aims to disrupt
  - Alignment with Russia is **largely defensive**, to increase room for maneuver in rivalry with the US. It is also very controversial inside China.
- China's diplomatic position is uncomfortable but manageable.
  - **China needs to balance its strategic relationship with Russia against its economic reliance on the US/EU.**
  - So it will support Russia in most ways but avoid the "red line" of arms sales.
  - China <u>may</u> be trying to nudge Putin into a cease-fire, which would relieve the pressure of this balancing act.
- Risk: the Ukraine conflict has solidified cohesion of US and its allies around liberal democratic values, and on technological self-reliance.
- Calculation: developed countries increasingly rely on China's market.
- *Incentives* to create alternatives to the US-dominated order (e.g. in payments) are on the rise; but *practical obstacles* remain immense.

China’s financial support for Russia is both open…

China's energy imports from Russia have soared

China imports of primary energy imports from Russia, by type, 12m rolling sum



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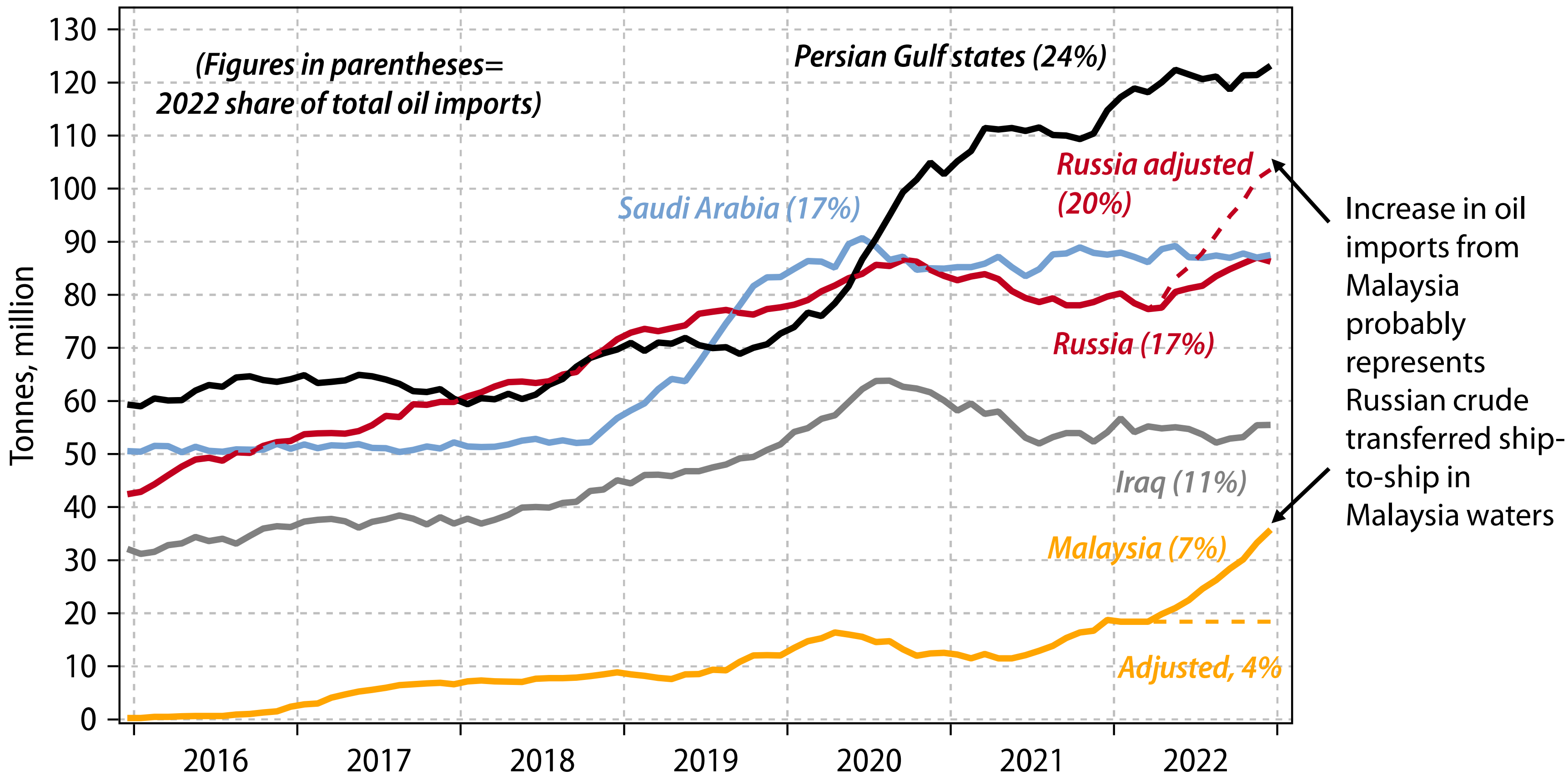
…and concealed

China probably imports more Russian oil than it admits

China oil imports by region, 12m rolling sum

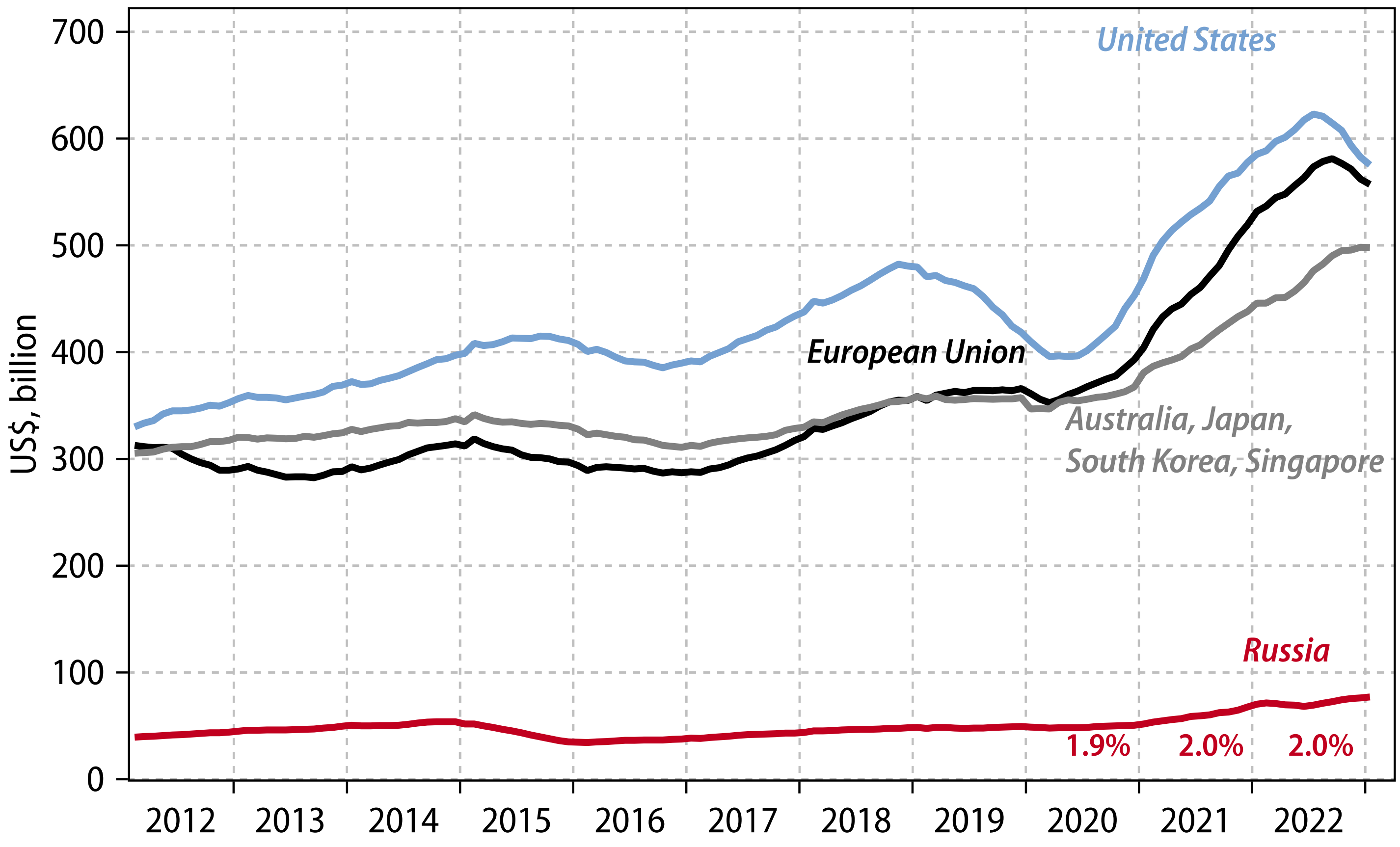


China Customs, Gavekal Dragonomics/Macrobond

China still needs to maintain access to US and allied markets

Russia's share of Chinese exports has not risen

China exports by destination, 12m rolling sums



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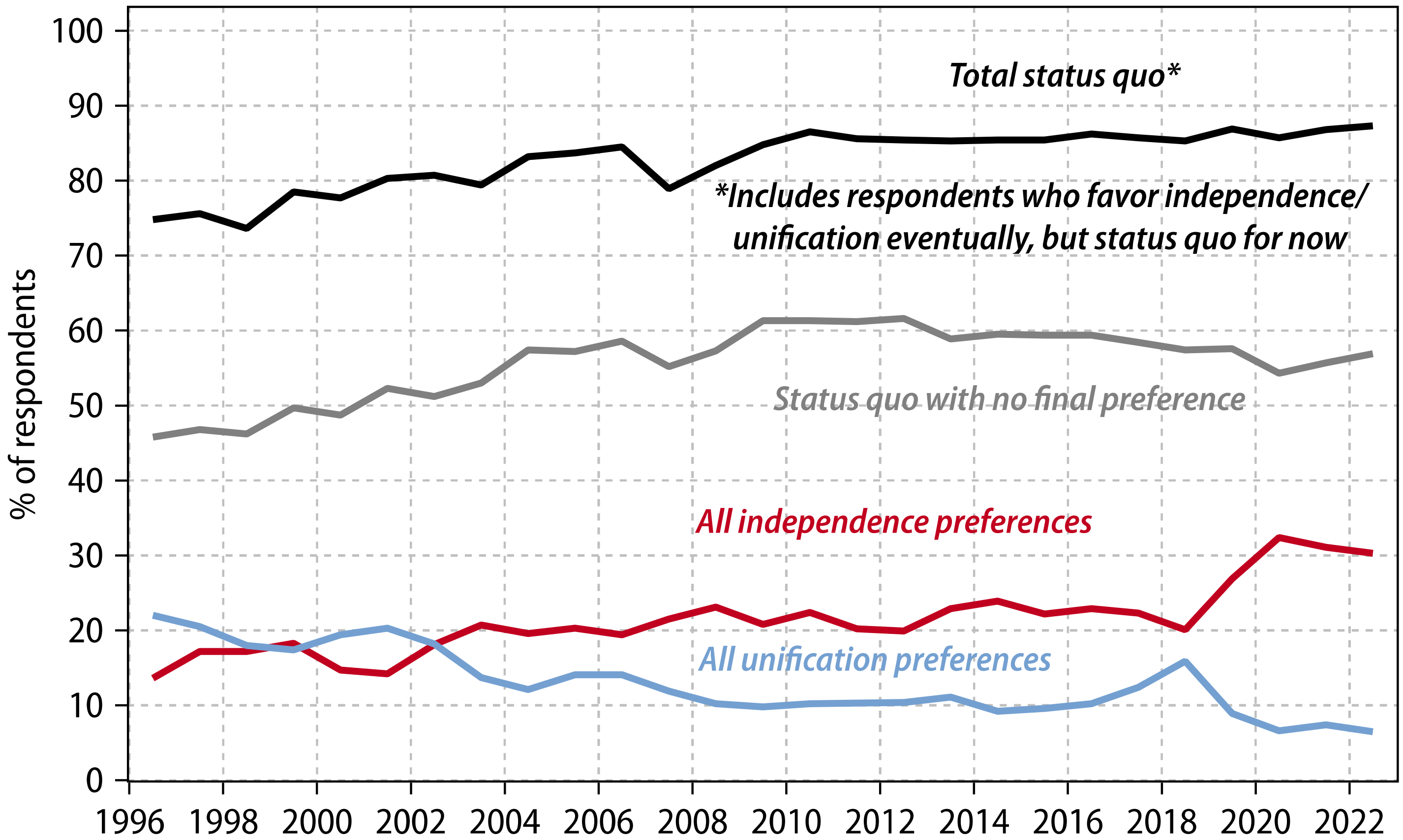
External risks: Taiwan

- Concerns have risen sharply
  - Russia : Ukraine :: China : Taiwan?
  - Belief that China has a timetable for reunification (take your pick: 2025/2027/2035/2049)
  - Increased pressure in US to provide clear security guarantee to Taiwan
- Reality: Risk of China acting unprovoked is around zero
  - Status quo favorable to China
  - Zero evidence of a timetable; Xi doesn't want to lose Taiwan but doesn't need to take it.
  - Economic/financial cost of invasion extremely high
  - China's engagement with the world entirely different to Russia's
- Risk of provocation by US/Taiwan
  - China fears US/Taiwan are locking in a path to independence.
  - 2023 US congress visits; 2024 Taiwan/US presidential elections.
  - **Economic coercion** more likely than war.

Public opinion in Taiwan overwhelmingly supports the status quo

Taiwanese favor status quo, though independence support rises

Public opinion poll preferences for Taiwan independence or unification with PRC



National Chengchi University, Gavekal Dragonomics/Macrobond

External risks: US-led economic pressure

Biden administration China policy is containment, a.k.a. “invest, align, compete”

- Infrastructure bill, CHIPS and Science Act, Inflation Reduction Act deliver ~$1 trn in support of industrial policy and infrastructure.
- Diplomatic efforts (+ Ukraine war) have brought EU closer to US position on technology controls on China; trilateral chip equipment ban secured.
- Export controls tightened, especially on chips; limited controls on **outbound tech investment** via CFIUS may come in May.

But there are limits:

- MNCs remain bound to China by market, production efficiencies and innovation cycles.
- US green energy goals will require major Chinese inputs.
- Allied countries will balk at controls that go beyond clear dual-use capabilities.

US export and outbound investment controls

Next up on export controls:

- Dept of Commerce may increase the number of semiconductor technologies subject to export license from 17 to 30
- Several more Chinese chipmakers may be added to the entity list (CXMT and Hua Hong are likely candidates)
- Huawei export licenses could be revoked

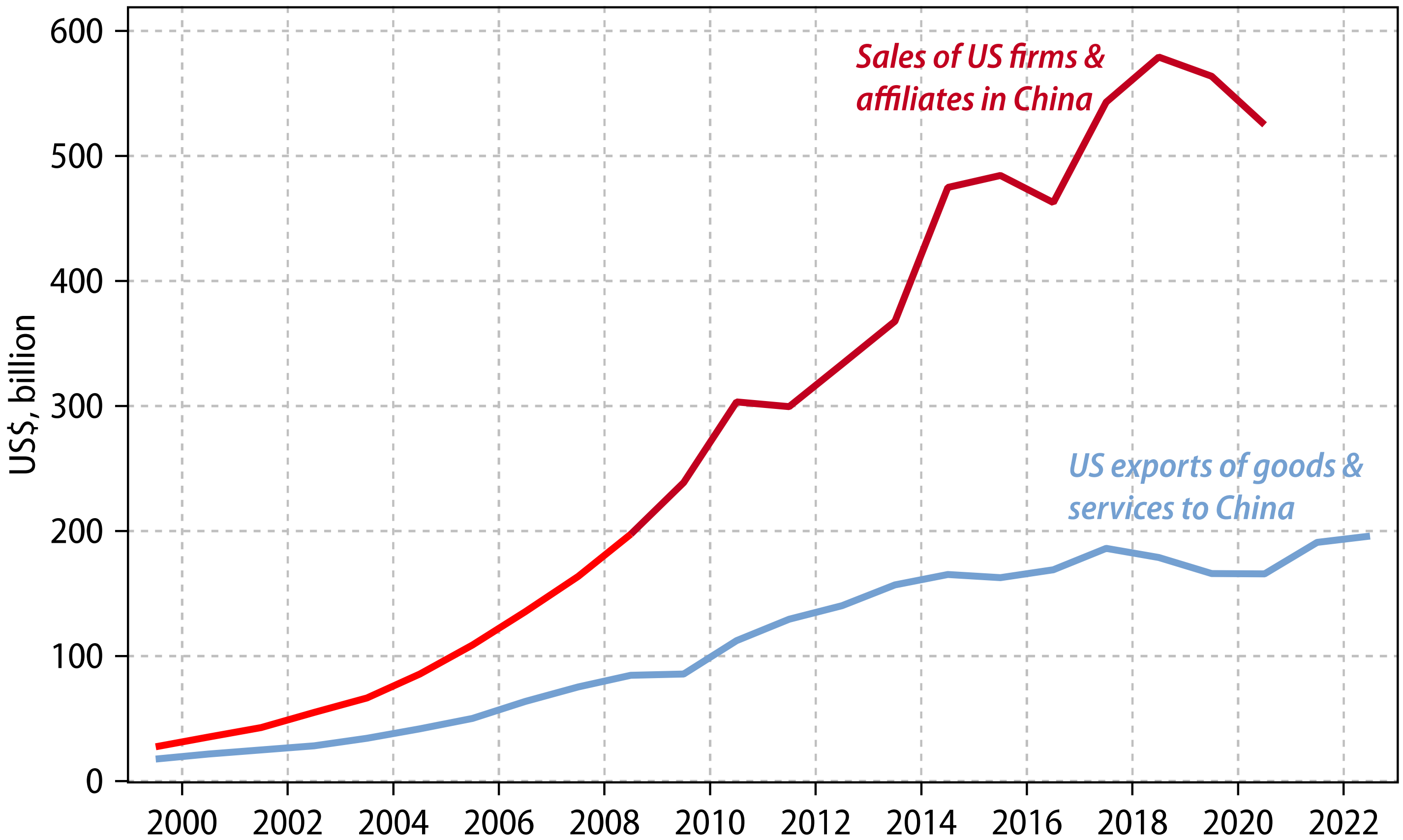
Outbound direct investment controls (late spring):

- Investments in semiconductor technologies named in October 7 policy will be banned
- Notification of investments in other semiconductor sectors (e.g. quantum and AI) will require notification
- Other limits on AI-related technologies
- Administered by Commerce and Treasury/CFIUS
- Main target: VC/PE funds
- Still undecided: how is "US investment" defined?

Constraint: China is non-optional for most MNCs

The US-China economic relationship is much bigger than trade

Domestic sales in China of US firms, vs US exports to China, US$bn



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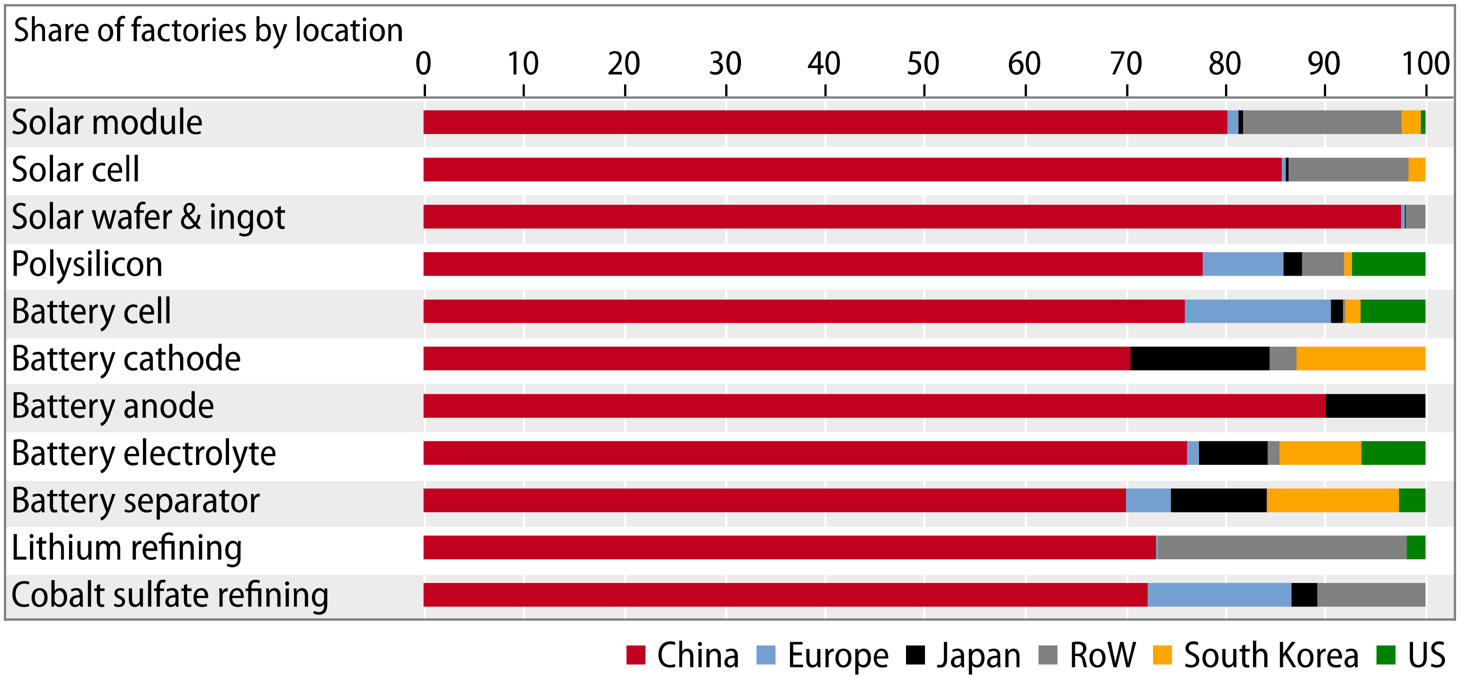
Constraint: climate goals incompatible with China-free supply chain

China dominates clean energy manufacturing



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China is beginning to push back, carefully

- In the trade/tech war China has mainly practiced "strategic restraint": more business dependence on China is their leverage
- One big exception: Boeing planes
  - ➢ 737-MAX planes flew again in China in Jan 2023, after 4-year grounding
  - ➢ Boeing has had no new orders since 2018, and 138 planes on order have not received import clearances; China revenues fell from $14bn to virtually nothing
  - ➢ Recent sale to Greater Bay Airlines in Hong Kong may signal a thaw
- China is now selectively (and very carefully) retaliating in tech:
  - ➢ Micron cybersecurity investigation by CAC
  - ➢ Likely non-issuance of merger approval for Intel/Tower, MaxLinear/Silicon Motion
  - ➢ Possible restrictions on rare earths and rare-earth magnet technology

‘Dual circulation’ is alive in spirit if not in name

- The big message from Beijing now is that China is “open for business”
- At the margin, European companies may get more benefits, but US firms are not being left out:
  - Wholly-owned asset management licenses have been issued to Fidelity, JP Morgan, and Neuberger Berman
  - Tesla expands its wholly-owned Shanghai site with battery plant
- At the same time, self-sufficiency plans grow, especially in semiconductors:
  - A “new-style whole nation system” for core technologies
  - Supervised by the new Party-controlled Central Science and Technology Commission
  - Implies more top-down control; a modulation of the “venture capital state” approach of the last decade.

The balance sheet: China's investibility

- **Short-term economy:** Recovery in 2023, but not a blowout.
- **Long term economy:** Substantial potential catch-up growth from technology advance and rising consumer incomes, constrained by property adjustment and financial delevering. Average growth of 2% - 5%, depending on extent of competition/financial reforms. Some sectoral returns should be much higher.
- **Regulatory/corporate governance risks:** Private sector is very much alive, but high-multiple growth (as in internet) is not.
- **External risks:** US will continue to widen the scope of tech controls. China will <u>not</u> seek military solution in Taiwan.
- **Investor home-country risk:** China is least "investible" for US-based investors; most investible for non-Western investors.

Contact and disclaimer

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