RBC BlueBay Asset Management

China: growth trajectory paused or broken?

Notes from the road

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Emerging Markets Equity team

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"Beijing is now ranked 489th in IQAir's report of the world's most polluted cities, which is significantly better than many others, such as New Delhi which is ranked 9th."

Driving across Beijing at the start of January this year, I reminisce about my first visit to the city just before the 2008 Olympics. Back then, the Chinese capital was under construction, and the skyline looked dusty and dirty. There was a strong sense of being in the midst of a fast-growing emerging country.

Fifteen years on, the city's impressive buildings are evidence of its status as a fully-developed metropolis, while the air is crisp and the sky blue, with no apparent pollution. Beijing is now ranked 489th in IQAir's report of the world's most polluted cities, which is significantly better than many others, such as New Delhi which is ranked 9th[1].

The wide avenues with large cycling lanes remind us of how, famously, there used to be 13 million bicycles in Beijing. This number has since dropped to levels similar to capital cities in developed countries, where many residents use shared bicycles as part of their commute to work.

Everyone we meet loves living in Beijing, despite the elevated cost of living, as the city is seen as more relaxed than Shanghai (the financial capital of China) and is also more diverse.

Moving south to Shenzhen, we are equally impressed with the modern feel of what was a village 40 years ago and is now considered China's Silicon Valley, with 12 million habitants and half an hour's drive from Hong Kong.

Travelling around China provides a striking reminder of the incredible developments the country has undergone over the past 20 years. This has been achieved notably due to the hard-working culture of the Chinese people, something which was apparent to us throughout our trip. For instance, we started our meetings on a Sunday and continued with a full agenda for six days. There is no working from home in China.

[1] World's most polluted cities (iqair.com).

The urban skyline of Beijing.

Buildings under construction on the outskirts of Shenzhen.

With the extreme pessimism currently surrounding China, it is easy to forget that it has achieved a very high level of economic growth and is now a middle-income country, with GDP per capita of USD13,000 compared to Brazil at USD9,400 or India at USD2,400[2]. Historically, this level has been challenging to surpass and many emerging countries have fallen into what has been termed the 'middle-income trap', where such countries fail to reach developed markets status. South Korea and Singapore are two notable exceptions. However, most countries don't have adequate institutions, resources and stability, as well as a suitable political environment, to successfully implement the reforms needed for continued development. Our trip highlighted that China is positioned exactly at this crossroads and continued economic growth will depend on the path chosen by the leadership.

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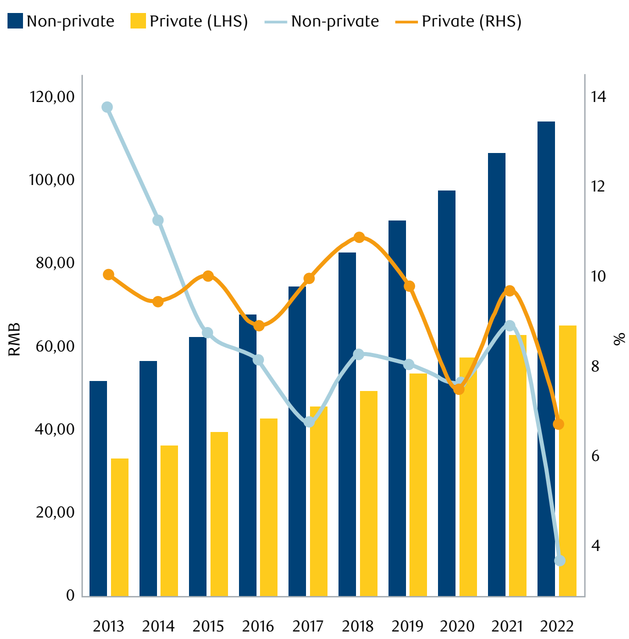
The challenges are both internal and external, as the geopolitical environment has dramatically transformed in the past few years and China has emerged as a superpower alongside Russia and India, which has created tensions with the West. Domestically, with China's high debt level constraining investment and immense urbanisation reducing the need for infrastructure spending, the country needs to increase domestic consumption for its next phase of growth. It is clear that China is entering a new chapter of lower growth and there is a significant risk of stagnation.

'Low confidence', 'downtrading', and 'oversupply' were the words most used in the many meetings we had during our week in Beijing, Shenzhen, and Hong Kong. Chinese people have been used to at least 5% wage growth per year over the last two decades (Exhibit 1) and they have also seen their property investments, the main wealth creation instrument in the country, increase year-on-year. However, since last year job security has decreased, with news of many companies laying off staff. Overall, Chinese citizens feel poorer, and their reaction has been to save more and spend less, with downtrading the latest trend.

Exhibit 1: Growth in average annual salary

Year-on-year growth and average salary increase



Source: National Bureau of Statistics (china-briefing.com).

[2] World Bank, 2022 data.

Luxury goods sales have started to slow down, as we witnessed in an upmarket shopping mall in the financial district of Beijing, which was empty on both a Sunday and Monday afternoon. Aspirational foreign brands still have a future in China, but in the current challenging consumer environment, local players are at an advantage. One unusual area where we have seen an increase in market share for foreign brands is sportswear; local players, Anta and Li-Ning, have attempted to compete with the likes of Nike and Adidas by launching high-end products. However, we felt that their efforts were not paying off when we compared traffic in stores. The sportswear sector is one of the bright spots within the consumer space, with the government actively promoting physical activity and a more athletic look favoured by the younger generations. We also noticed the transition from formal to athleisure wear, notably in the workplace where employees, especially in innovative technology companies, wear sneakers and tracksuit bottoms to work.

An empty high-end shopping mall in Beijing.

Another vast and fascinating area is online shopping. The sector is maturing in China and is undergoing a huge transition away from the incumbents, Alibaba and JD.com, which operate very much like Amazon. As players fight for market share, these companies have both been disrupted by the blending of online shopping and social media. JD.com's management pointed out that content is the main way to acquire users and maximise sales, and it noted that tech company ByteDance has been particularly successful in this area with its social media/e-commerce platform, Douyin. These companies are also benefitting from the downtrading environment, with platforms like Shein, Pinduoduo and Douyin selling low quality products at very modest prices. However, we feel that the trend towards such goods may stabilise once confidence is restored and consumers feel comfortable again spending on higher quality goods and better service.

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On the topic of geopolitics, several people we met described their sadness at the deterioration of the relationship between their country and the US, the latter of which was seen as aspirational by many. It is clear that China's current leadership is willing to take a more confrontational approach, despite being aware of its dependence on the West.

We also had many discussions about Taiwan, and it became evident that no-one could see China invading Taiwan in the coming years. The government is aware of the catastrophic impact an invasion would have, due to the country's dependency on trade. Despite its large size, China is the world's largest importer of agricultural products, with Brazil representing 20% of such imports, followed by the U.S. and New Zealand[3]. An attack on Taiwan would most certainly trigger sanctions in terms of exports to China, which would likely lead to food shortages in the country. Even before the beginning of the war in Ukraine and the subsequent isolation of Russia, China had been looking at reducing its dependence on the West by developing internal production, as well as establishing alliances with other emerging countries, such as African nations. One risk we see for China is that the focus on reducing dependence on the West becomes all-consuming and its attention on short-term issues is diminished as a result.

During our trip, we also heard discussions about the treatment of minorities in China, notably the Uyghurs Muslim population. In China, 92% of the population is of Han ethnicity and there are 55 other ethnic groups across the country, often in poorer and less developed areas. We heard how the government provides preferential treatment to minority students, for instance when it comes to university access, and it has looked to increase the participation of minorities in the country's institutions. At the same time, it is clear that the government's objective is to achieve 'sinification' through the adoption of Mandarin as a common language and restrictions on religious customs and clothing. The end goal is to integrate ethnic minorities to ensure social stability. Tibet and Xinjiang are the two provinces where most resistance has been seen, hence more aggressive government action[4].

3 China increasingly relies on imported food - that's a problem (cfr.org).
4 Ethnic groups in China (orcasia.org).

Finally, we conducted a deep dive into the real estate market, clearly one of the main headwinds for China. In the summer of 2021, the government, alarmed by the level of debt in the sector and the oversupply of homes, started to reign in the debt of private property developers. As can sometimes be the case in China, the policy changes were extreme and led to many property developers becoming insolvent and defaulting on their debt. This caused losses for the entire financial system, including many individuals who were invested in wealth management products which are often linked to property developers' debt. At the same time, the oversupply and subsequent mismatch between supply and demand has led to a large decline in property prices, in the region of 30-50%, based on our conversations. Given that a large portion of Chinese wealth is tied to property, we have seen a surge in sales in the secondary market in anticipation of further price falls. Currently, property demand is still weak, with little interest from young people, who view the sector as risky. Additionally, as we also see in the West, younger demographics tend to prefer spending on experiences rather than assets.

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Our meetings with property companies painted a challenging picture in the short term. There is still significant property inventory to digest, the natural demand coming from urbanisation is slowing, and the price weakness of the past few years means that it will take several years for investors to return to property as an investment.

Baidu's self-driving robotaxi service, Apollo Go.

It is crucial, however, that the overhang created by the non-performing debt is dealt with imminently, otherwise the country could face a similar situation to Japan several decades ago, which led to very low growth until recently.

In conclusion, travelling to China after a break of several years highlighted the speed of growth in the country and how advanced China is compared to its neighbours, such as India or Indonesia. Clearly, China is currently facing many headwinds, but we believe that if the government manages to restore confidence in the business community and consumers, the country could resume its growth trajectory. It will be crucial to follow the implemented policies in the coming months, as a high base in 2023 will make the targeted economic growth for 2024 difficult to achieve without some kind of stimulus or a resolution of the property sector issues.

All eyes will be on the third plenum, expected to take place in March this year. Out of the seven plenums typically held during the five-year term of the central committee, the third one is the most important for economic growth, as this is when reforms are decided. This should provide a clearer view of the government's priorities and, in a positive scenario, could be a game changer for China and investors in the country.

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