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Chinese economic hopes too high?

Market Comment, January 2023

The surprising change of course in the coronavirus policy of China's leadership has led to a significant recovery in Chinese and other Asian financial markets since December. In taking this step, the government in Beijing is attempting to counter the social protests that have emerged among the Chinese population, the extent of which has come as a surprise to observers both inside and outside China. However, the vaccination coverage of China's vast population is not yet sufficiently advanced to boost economic growth and corporate earnings on a sustainable basis. It is therefore likely that a healthy dose of scepticism will remain the order of the day with respect to the growth expected by the market consensus.

Renewed shoots of optimism as regards developments in China and Asia have recently been observed on the financial markets. While not doing so officially, the Chinese President Xi has indeed moved to revise China's previous zero-COVID policy in the wake of the massive social protests seen in major Chinese cities. The easing of the hitherto extremely strict lockdown and quarantine regulations has moved the analyst consensus to expect a marked recovery in China's economy during 2023, with economic growth of 4.75% to 5% now being predicted after approximately 3% in 2022. This contrasts with the growth of 0% to 0.5% forecast by the market consensus for the US and European Union in 2023.

It can be assumed that there will be a partial recovery in both consumption and mobility, especially against the backdrop of brisk travel activity around the Chinese New Year. It is precisely this travel, however, that means a rapid spread of the coronavirus and perhaps also new variants can be expected. This is likely to lead to illness-related production losses in China. These losses could, in turn, reduce supplies of Chinese products and components once more, pouring fuel on a fire that had previously been tamed, and also hinder the decline of inflation in Western countries due to supply shortages. In this case, weaker production growth in Europe or the US owing to a lack of components from China would come as little surprise. Until the Chinese population has been sufficiently vaccinated with effective vaccines, China should therefore not be expected to provide any significant growth impetus to the global economy. What is more, the measures of the political leadership in Beijing aimed at stimulating the Chinese economy do not yet appear particularly considerable in scope. The reduction in reserve ratios for banks and lending rates cannot be quantified as significant enough to provide massive support to the interest-rate-sensitive segments of the Chinese economy.

> "Given that the economic reality in China has often failed to live up to the market consensus, a healthy dose of scepticism will also remain the order of the day in 2023."
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> Gérard Piasko, Chief Investment Officer

The economic data from the real estate sector, which is important for the Chinese economy, remains unsatisfactory. Levels of investment in China's real estate sector have, for example, declined markedly once more relative to the previous year, with a massive contraction being observed. The real estate segment is one of the Chinese economy's most important areas, accounting for a share of around 25% to 30% of the country's economy on its own. The latest data on the Chinese economy, including for segments outside the real estate sector, has been even weaker than had been expected by the market consensus. Here, it is interesting to note that it has not only been the leading indicators for industrial production that have been weak and indicated a contraction. Data from the service sectors has also disappointed and pointed to unsatisfactory economic growth in China, coming out even weaker than the economic data reported on the production side of the Chinese economy.

Chinese corporate earnings, which have so often been overestimated in the past, must continue to be watched with a wary eye. This is because if they disappoint once more, the high total returns expected by the consensus for the Chinese equity market may prove to be overly optimistic. Incidentally, this would also fit in with the trend of generally overblown earnings growth forecasts being issued by bank analysts worldwide at the outset of the year. Come the end of the year, it normally turns out to be the case that the market consensus has overestimated corporate earnings by at least 5%, with analysts often being as far as 10% adrift in their forecasts, as various studies have shown, especially from the US.

Conclusion: The Chinese and Asian financial markets in general have welcomed China's reopening following its strict lockdown measures with massive upward movements and have thus already priced in significantly stronger economic growth. Only the future will reveal whether this growth can happen as comprehensively and quickly as the recovering markets are already anticipating. Given that the economic reality in China has often failed to live up to the wishful thinking of the market consensus in recent years, a healthy dose of scepticism will likely also remain the order of the day in 2023.

Gérard Piasko

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