

Investment Views

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Rousing the Dragon

Is China turning Japanese?

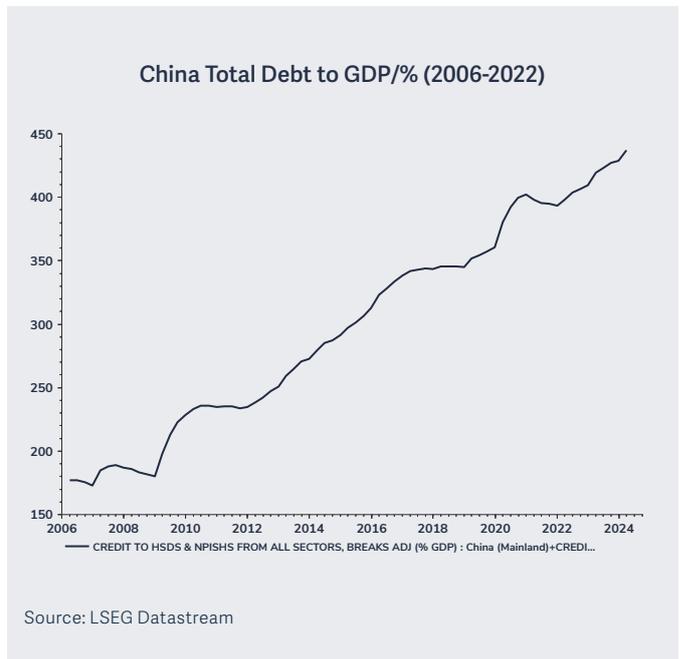
The concept of a balance sheet recession first emerged through the work of economist Richard Koo, who developed the framework whilst analysing Japan's economic stagnation in the 1990s. He concluded that the bursting of the country's real estate and stock market bubbles sparked a prolonged period of deleveraging that saw businesses and households switch to prioritising debt repayment over investing or spending. This transpired despite ultra-low interest rates and various other stimulus measures, fostering a self-reinforcing cycle of stagnant GDP growth and weak inflation.

The most acute phase of this process lasted for roughly 15 years, from the early 1990s to the mid-2000s, culminating in what is now commonly referred to as Japan's "lost decades". Fast forward to today and the Japanese economy is in a healthier state with corporate balance sheets largely repaired, growth on a firmer footing and some signs of modest inflationary pressures starting to emerge. This means its balance sheet recession is technically over even though the scars from the prolonged and persistent debt malaise still linger.

Which brings us to another country facing a colossal debt burden.

Concerns that China is experiencing its own balance sheet recession have been mounting for some time. Between the early 1990s and the mid-2010s, the Chinese economy experienced a rapid ascent with GDP growth rates regularly clocking in above 10% p.a. This so-called "economic miracle" was fueled by an investment-driven growth model, underpinned by massive amount of state-backed borrowing. The end result was an unprecedented industrial expansion, a booming real estate market and a general improvement in economic conditions for the bulk of the country's near 1.5 billion population.

Easy access to credit intensified during the 2008 financial crisis when the authorities unleashed a huge stimulus to help stave off the global downturn. In many ways the approach worked with the Chinese response widely recognised as the key factor in helping the world economy avert a deflationary bust, but the policies birthed longer-term consequences and further accelerated China's reliance on debt to sustain economic growth. As the chart below shows, total credit use surged from 180% of GDP in 2008 to almost 450% now, with the corporate and property sectors accounting for most of the borrowing.



The first cracks in China's overleveraged system started to emerge in the mid-2010s when property prices in key cities began to soften. The headwinds intensified in 2016 when President Xi launched a major deleveraging campaign in a bid to wean the economy off its debt addiction. Significantly, the country's recent economic troubles can be traced directly back to Xi's efforts to quell speculative borrowing and numerous other "misguided" uses of credit.

The impact of this multi-year clampdown has been stark. New home prices have fallen and property sales volumes have almost halved from their peak levels. In response major real estate developers, like Evergrande and Country Garden, have collapsed leading to a surge in bad loans and heightened stress in the banking system. Unsurprisingly, this has all weighed on the broader economy with headline GDP growth now struggling to match the government's 5% target. As a result, deflationary pressures have intensified; core CPI has seldom registered above 2% throughout the past decade and came in at just 0.1% y/y in September.

Similar to Japan's experience, the economic downtrend has festered despite falling borrowing costs. The Chinese 10yr sovereign bond yield has halved from 4% in 2018 to a prevailing all-time low around 2%, yet debtors have remained cautious, preferring to reduce existing liabilities instead of accumulating new ones. Much like its Asian neighbour, the Chinese stock market has also suffered. At the end of August, the A-share index, which represents companies listed on mainland exchanges, was showing just a 12% total return (RMB terms) in the eight years since Xi's restrictive policies were first rolled out. By comparison, the FTSE All-World global stock market more than doubled (in USD terms) over the same period.

The prolonged nature of this strong bonds/weak equities dynamic in Chinese markets shows just how steadfast both monetary and fiscal policymakers have been in pursuing a less debt-dependent economy. However, judging by September's "bazooka" stimulus announcements, change is afoot.

Shortly before October's Golden Week national holiday, the Chinese authorities signaled a surprising and significant shift. One that reflects a growing concern over the economic slowdown and the threat of deflation.

The People's Bank of China (the Central Bank) led the charge with a series of measures aimed at reviving both the real estate sector and the domestic stock market. Key lending rates were lowered (including those on existing mortgages) and various property market restrictions were softened; most notably the deposit requirements for first time buyers.

More striking were the liquidity tools deployed to boost share prices, including a reduction in stamp duty rates, an easing of margin financing limits and funding support for share buybacks. This marks a profound change from prior interventions, which had largely ignored the impact on financial markets, and suggests the authorities now view higher share prices as a foundation for encouraging private sector players to borrow and spend again.

The news had an immediate impact on the A-share market which, aided by a high degree of short-covering, surged by almost 30% in just two weeks. It has since consolidated a little, but remains close to its 2024 highs. The Hang Seng followed suit with an abrupt 35% gain around the quarter-end, taking it from one of the worst-ranked indices for year-to-date gains to a global leader in the blink of an eye.

For investors two key questions spring to mind. Will the rally last and what does it mean for economies and markets elsewhere?

Regarding the former, Chinese policy appears to have turned a corner and, if history is any guide, the rally in domestic equities has further to run. This was a massive policy response, bettered only by the measures deployed around the pandemic and the 2008 financial crisis. Typically, such large liquidity injections have fueled "stimulus rallies" that see local stock markets produce at least 50-100% trough-to-peak gains (source: Gavekal Dragonomics). So with Chinese stocks up just 30% from their late September low, further upside seems probable over the coming months.

That said, despite cheap valuations, there must be a notable improvement in economic growth and corporate profitability for a prolonged bull market to emerge. In turn, this needs China's balance sheet recession to end.

It is difficult to envisage this scenario playing out in the absence of greater fiscal support; tax cuts and targeted government expenditure that spur a sustained increase in nominal GDP. Ideally this would be led by the high-tech sectors rather than the capital-intensive industries that drove the 1990-2010s economic boom. Encouragingly, there are tentative signs of the fiscal purse strings being loosened, but intervention likely needs to be bolder and more regular if the stock market rally is to persist into 2025 and beyond.

As for whether or not China's recent trials and tribulations matter for the rest of the world, the answer is a resounding yes. Simply put, the country remains a principal engine for global growth and inflation so persistent stagnation would mean China continues to export deflation, capping growth rates, cost pressures and bond yields well beyond its borders.

Conversely, if we are in the foothills of a resurgent Chinese economy, Western growth and inflation rates are more likely to rise than fall from current levels. On the one hand, this would be good for risk assets, especially the more cyclical areas of equity and bond markets. On the other, the scope for rate cuts in the US, UK and European economies would diminish significantly, posing a threat to their liquidity-fueled equity and credit market rallies.

On balance it will likely take a lot more stimulus for China to re-establish a stronger-for-longer growth trajectory, but the path to get there speaks to further gains for Chinese equities. After a few years of frustratingly sedate returns for our dedicated A-share exposure, the position looks set to benefit from the liquidity support that flows from this policy volte-face. This makes it appealing both as a standalone allocation, but also as a hedge against a potential reflationary episode in China that would, in turn, pressure the more rate-sensitive assets that have been performing very well of late, especially US equities and gold.

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