Citi Global Wealth Investments

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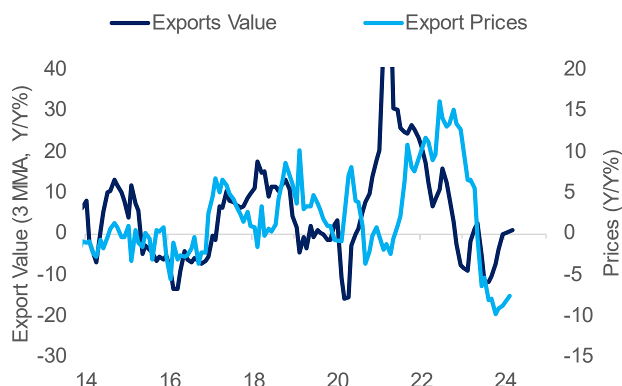
Ken Peng
Head, Asia Pacific Investment Strategy

Calvin Ha, CFA, CAIA
Senior Asia Pacific Investment Strategist

China: Supply Side Effects

- Some green shoots in Chinese macro data have stoked some hopes for a next round of recovery. To the contrary, the stubbornly high US inflation and the stubbornly supply-sided policy in China may set off another round of weakness in Chinese currency and equities. Investors should consider hedging the potential impact of a weaker Chinese yuan (CNY).
- The rationale for focusing economic policy on the supply side includes self-sufficiency and industrial upgrade, as well as counter measures against US sanctions and protectionist policies. We look at the potential side effects.
- Side effect #1: Overcapacity and deflation. Similar to solar panels and steel, investment in industrial capacity without commensurate demand growth creates overcapacity. The investing phase could produce stronger GDP growth, such as seen in recent PMI numbers. But once investment slows, deflation would likely deepen.
- Side effect #2: Export dependency and trade tensions. To digest overcapacity, China would have to depend more on exports, thereby exporting deflation. But China's economy is too big to return to an export driven model, especially as US and European governments are pushing back with more protectionist policies.
- Side effect #3: Currency and asset risks. China's central banks had recently tested waters for further CNY depreciation, particularly if additional sanctions and protectionist policies materialize. Though the mispricing isn't as bad as in 2015, CNY depreciation could still test the lows we saw in January in Chinese equities. In this backdrop, investors may hedge currency risk as current hedging costs are still low, while high dividend state-owned companies are likely to be favored.

FIGURE 1: Exporting deflation—China's rising export growth and falling export prices



Source: Haver Analytics, as of March 2024.

FIGURE 2: Chinese equities may test January lows again if the currency weakens

Source: Bloomberg, as of 5 Mar 2024.

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3 THINGS TO KNOW

China's recent data improvements came from policies to boost select industries, while other structural problems remain unresolved. The inflation scare in the US also reduced the odds of easier external conditions.

President Xi is focusing economic policy on "new productive forces" and "common prosperity." These are likely to create side effects including, overcapacity, deflation, export dependency, trade tensions, as well as pressure on currency and asset prices.

Investors should consider hedging CNY depreciation risk, while volatility remains historically low. Equity investors are likely to focus more on immediate cash returns from dividends rather than the promise of future growth.

Supply Side Effects

Recently, some of China's macro data improved. PMIs for manufacturing and services rebounded and are in expansion (**FIGURE 3**). Growth in industrial production, fixed investment and exports beat expectations. Inflation also returned to positive territory. These upbeat economic surprises lifted MSCI China index by 13% since the January low (**FIGURE 4**).

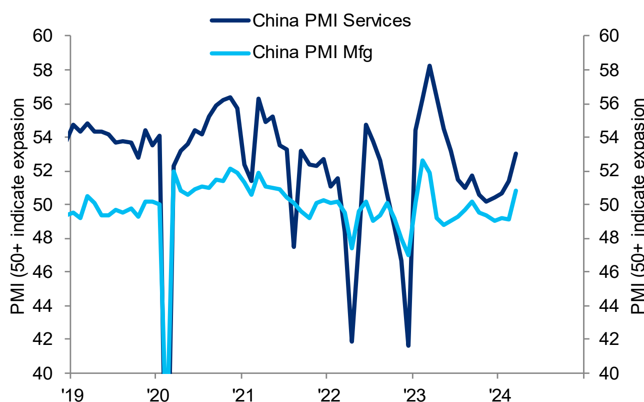
We noted previously that since valuations are so low, Chinese equities may be prone to sharp rebounds if the economy improves. But sustaining the rally would require resolving some domestic structural and external challenges, which we believe remain key hurdles to recovery.

Domestically, there is a singular policy focus on boosting the supply side. Stimulus policies over the past two years were directed at infrastructure and industries where China has an edge, like electric vehicles (EVs), and those where China has a strategic objective, such as semiconductors and biotech. Meanwhile, there were no policies to lift household demand despite clear lack of consumer confidence amid a real estate depression. Even the consumer related programs to swap old appliances and cars for new ones are administered through producers.

External factors are related to geopolitics and the Fed. Geopolitical tensions can potentially escalate, partly because of the side effects of supply boosting domestic policies. As for the Fed, there were some hopes that rate cuts could ease pressure on the Chinese yuan and allow the People's Bank of China to ease monetary policy more broadly. But the stubbornly high US inflation is likely to at least delay that scenario.

In this report, we discuss the rationale for such a policy priority and the side effects that it would bring, with potentially significant market implications.

FIGURE 3: China's PMIs rebounded in March



Source: Haver Analytics, as of March 2024.

FIGURE 4: Chinese equities rebounded as macro data beat depressed expectations

Source: Bloomberg, as of 10 Apr 2024

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Why Supply Side?

At the conclusion of the National People's Congress, President Xi highlighted that "new productive forces" are the focus of economic policy, while "common prosperity" is the core objective of economic development. These two tenets are likely to govern China's economic policy for years to come.

New Productive Forces (NPF) are industries that China is leading or strives to move ahead, including electric vehicles, batteries, semiconductors, biotech, drones, etc. The concept is to boost production in these higher value-added industries, such that more incomes go to workers and the economy can grow this way.

The trouble is that not many people are needed to produce high tech products because of the high hurdles for skill and precision. The Economist estimated that China had already poured $1.6 trillion into the NPF industries annually, accounting for 20% of China's total fixed investment, and equivalent to 43% of the US' total investment. But this did very little to shore up confidence for households, businesses, or investors. And as far as precedents go, a misguided program to boost steel production 60 years ago had catastrophic results.

The Common Prosperity goal can help explain the reluctance to stimulate demand. Aside from containing systemic financial risks, the policy addresses did not seek to resolve the decline in real estate, which is a key source of weak demand. Since real estate is one of the key drivers of wealth inequality, removing this hurdle would be consistent with national policy. Together with declining population, the real estate sector is likely to see a long period of milder declines and stagnation, following the past three years of sharp decline.

Common Prosperity can also explain the lack of business confidence. The decline in real estate and the pandemic control policies have depleted local government financial resources. This has led to more financial burden on businesses to alleviate local government fiscal constraints.

There are two main rationales to adopt NPF and Common Prosperity policies.

- Self-sufficiency and industrial upgrade: President Xi had promoted the concept of dual circulation in his earlier posits on economic policy. This mainly involves reducing dependence on imports for critical economic factors such as food, energy, semiconductors, and just broadly higher tech, higher value-added products. It also means greater promotion of export competitiveness to ensure security in external finances.
- Countermeasure against US sanctions and protectionism: Since China cannot counteract US tariffs and sanctions with similar measures, massively increasing production capacity and bringing down prices could be seen as a way to inflict a cost on the US. As a result, if US authorities escalate sanctions and tariffs, China is likely to intensify capacity investment, which may have side effects as we discuss below, but it is seen as more effective than typical trade policies.

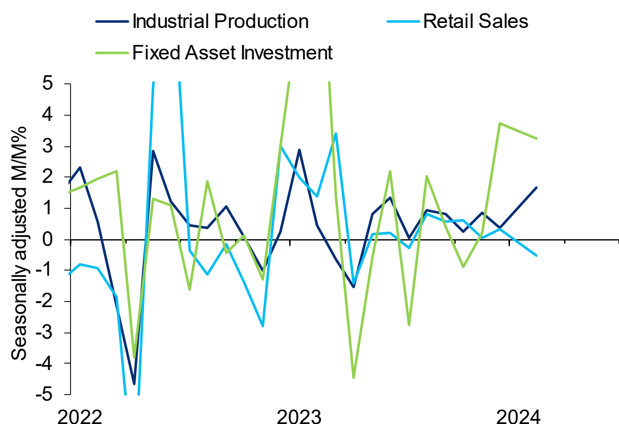
It is debatable whether these two rationales are valid or achievable. But it is clear that adopting these policies would have significant side effects.

Side effect #1: Overcapacity and deflation

Similar to solar panels and steel, investment in industrial capacity without commensurate demand growth creates overcapacity. The investing phase could produce stronger GDP growth, such as seen in recent PMI numbers noted above. But once investment slows, deflation would likely deepen. Deleveraging and capacity destruction are likely to follow. The imbalance was clearly shown in the January-February growth data, where industrial production (IP) and fixed investment made notable gains, while retail sales declined (**FIGURE 5**).

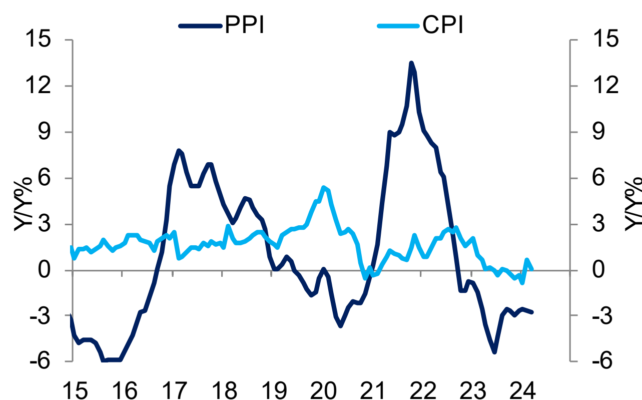
Despite the rebound in PMI data, both consumer and producer price deflation remain ongoing (**FIGURE 6**). After a brief holiday-driven bump in February, China's CPI fell back to 0.1%y/y in March. Aside from holiday related swings in food, travel and leisure, vehicles were a key driver of continued deflation. With renewed program to swap old for new, the deflation is likely to intensify when the program eventually expires. Producer prices (PPI) had fallen 0.6%q/q in the first quarter, and -2.8%y/y. The epicenter of deflation had shifted from mining to manufactured goods and durable consumer goods.

FIGURE 5: IP and fixed investment growth accelerated, while retail sales declined in Jan-Feb



Source: Haver Analytics, as of March 2024.

FIGURE 6: Despite bounces in PMI and CPI, China's producer prices remain in deflation



Source: Bloomberg, as of 10 Apr 2024

Side effect #2: Export dependency and trade tensions

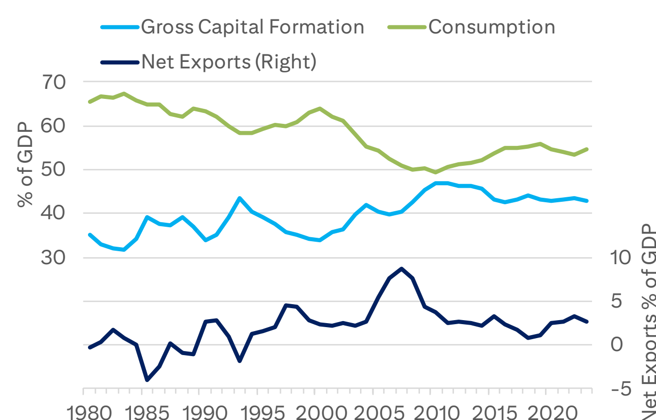
To digest overcapacity without stronger domestic demand, China would have to depend more on exports. But returning to an export driven economy is no longer a realistic option for today's China. The pressure on geopolitical tensions and risks of currency depreciation are increasing, especially if the Fed doesn't ease.

First, the size of China's economy is too big to be export driven again. After a brief pandemic-driven bump up in 2022, net exports made up 2.6% of China's GDP in 2023, still much higher than the 0.8% nadir reached in 2018 before the trade war really kicked in (**FIGURE 7**). In 2023, China accounted for 14.5% of global exports, also higher than the 13% share in 2018. Even if we assume a return to the peak share of 15.2% in 2021, that will still not amount to meaningful boost to China's GDP.

As a result, boosting supply would be similar to exporting deflation. In the first quarter, China's exports went through notable holiday volatility, but still grew by 1.0%y/y. But export prices fell by 7.6%y/y, making for 9%y/y rise in export volumes (**FIGURE 1**). Meanwhile, imports grew by 1.2%y/y, with import prices 3.2%y/y higher, making for 2%y/y drop in import volume.

Moreover, any meaningful increases in China's exports could escalate geopolitical tensions, as European governments are joining the US to actively push back with more protectionist policies. In 2023, China's exports to the EU gained market share (**FIGURE 8**), particularly as high value-added products like EVs made headway. But the EU has recently begun to design a comprehensive plan to de-risk from China, as the US did earlier. Even while leaders of Italy and Germany are visiting China to discuss trade and other issues, anti-dumping measures against Chinese EVs are being discussed at home.

FIGURE 7: Net exports amounted to 2.6% of China's GDP, rising since the start of the trade war, while consumption and investment shares stagnated



Source: Haver Analytics, as of 2023.

FIGURE 8: China is gaining share of EU imports, while losing in the US

Source: Haver Analytics, as of Feb 2024

Side effect #3: Currency and asset risks

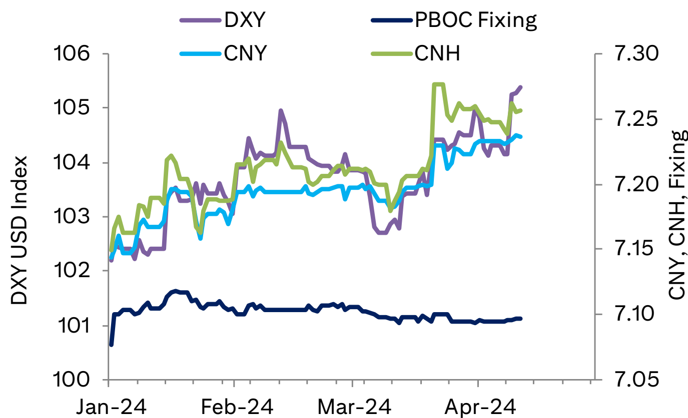
Continued domestic uncertainty and lingering USD strength have pushed CNY depreciation risks back to the foreground of investor concerns. And from a policy perspective, weaker exchange is consistent with boosting supply side activity. The mispricing of currency is not as bad as in 2015, but it is still a risk worth hedging.

Warning shot from PBOC**:** After the Swiss National Bank surprised markets by becoming the first major central bank to cut rates, the sharp depreciation of the Swiss franc pushed the USD stronger. On Friday, March 22, the People's Bank of China (PBOC) refrained from supplying extra USD liquidity and allowed the CNY to breach 7.20 level. Since then, the PBOC reiterated its determination to maintain exchange rate stability, with stable fixing and liquidity. But the episode was seen as a warning for what could happen if the USD strengthens sharply. After the March CPI report sent USD surging, the CNY weakened further to over 7.23 (**FIGURE 9**).

As we discussed earlier, trade protectionism continues on the rise. Candidate Trump raised the possibility of 60% tariffs against China. President Biden's administration continues to produce targeted sanctions and other restrictions. On her recent trip to China, Secretary Yellen reiterated US grievances against China's supply boosting policies and threatened additional sanctions against Chinese banks in association with the Russian war effort. If further sanctions materialize, additional USD strength and CNY depreciation would be likely.

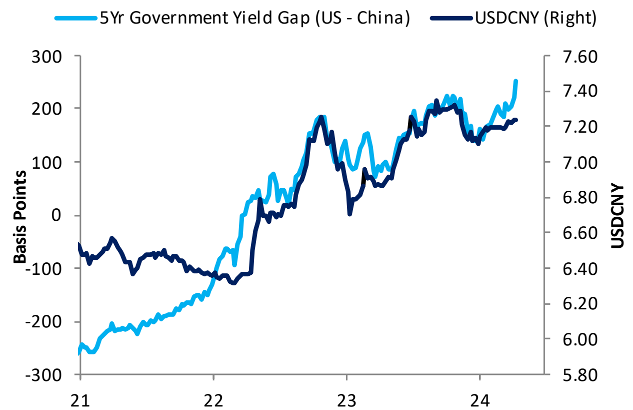
As to how much potential depreciation, we believe the mispricing of the CNY is not as bad as in 2015. The economic fundamentals are arguably worse, as evidenced by Chinese government bond (CGB) yields being 60-80bps lower now versus 2015. Fortunately, since 2022, the CNY had been closely following the fundamentals, or the yield gap between US and China. But since the start of this April, US yields have surged 40bps for the 5-year, while CGB yields fell by 10bps. This had widened the yield gap to nearly 250bps, and would be consistent with CNY above 7.40, compared to 7.23 currently (**FIGURE 10**). That said, the PBOC still has ample resources and tools to reduce currency volatility, including but not limited to daily fixing, intervention in funding markets, sale of FX reserves and higher Risk Reserve Ratios. The PBoC would likely prefer a more controlled pace of currency moves so as not to destabilize capital flows. As a result, potential CNY weakness is likely to be gradual.

FIGURE 9: CNY exchange rate is heavily influenced by USD moves even while PBOC fixing stays stable



Source: Bloomberg, as of 12 Apr 2024.

FIGURE 10: CNY had been consistent with US-China yield gap since 2022, but had recently deviated



Source: Bloomberg, as of 12 Apr 2024

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Implications for markets

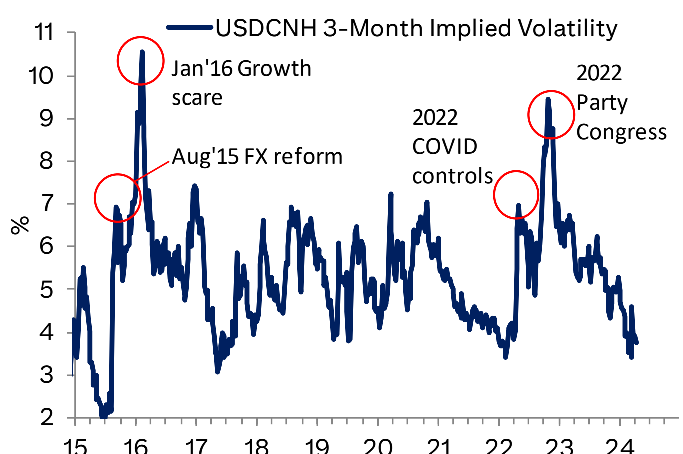
The impact of potential CNY weakening would depend on both external conditions and PBOC tolerance.

Since the start of 2022, the CNY had already depreciated by 14% versus the USD. The first half was accompanied by aggressive Fed rate hikes and a global correction, similar to the second half of 2015. But since 2023, global equities reversed its correlation with CNY depreciation, because global growth was stronger and the Fed was less hawkish, similar to 2016 (**FIGURE 11**). We suspect that the international spillovers of another potential round of CNY depreciation may be initially negative, but likely less extensive compared to 2015.

FIGURE 11: In 2015, CNY depreciation had significant spillovers to other markets in 2H 2015, but became less impactful after Fed turned more dovish in 2016

Source: Bloomberg as of 12 Apr 2024.

FIGURE 12: The cost of hedging CNY risk remains historically low, as volatility remains a fraction of what it had been in past periods of depreciation



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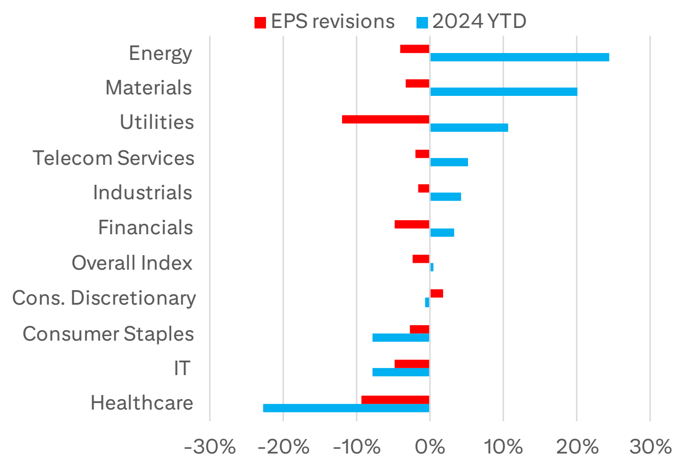
For those with direct CNY exposure, hedging costs remain historically low. Implied volatility for CNY is at the low end of the historical range. In the past two episodes of significant CNY weakening, volatility had surged to triple current levels (**FIGURE 12**). Volatility tends to surge when the market suspects that the PBOC is endorsing a market move to a weaker CNY.

For Chinese equities, some parts of the market have actually had strong performance this year, consistent with the policy tilt noted above. State-owned value sectors such as Energy, Materials, Utilities, and Telecom have outperformed dramatically versus high growth high valuation sectors including Healthcare, IT, and consumer sectors. This is despite the fact that earnings revisions had been negative across the board, with the outperforming Utilities sector seeing the biggest downgrades (**FIGURE 13**).

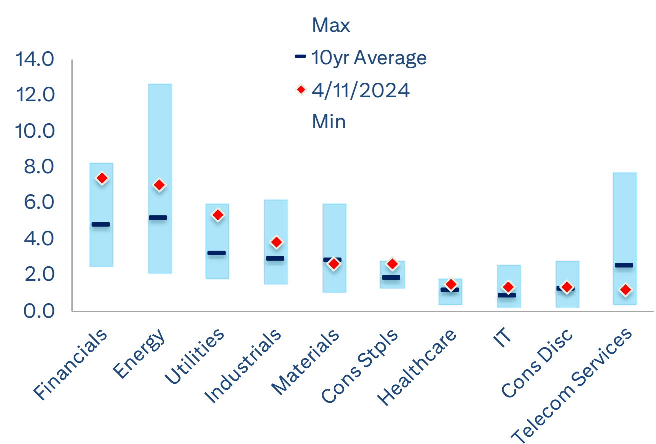
In this environment, dividends can be an important barometer for the outlook. Investors who still allocate to China are likely to favor immediate cash returns versus the promise of future growth, similar to a high yield bond market. This would favor stocks that pay a high dividend (**FIGURE 14**), which is consistent with national policy since many of the high dividend sectors are also state owned. Even some growth companies have begun to increase dividends, such as some of the earlier favorites in online gaming and e-commerce.

FIGURE 13: State-owned value sectors have vastly outperformed high growth sectors in 2024 to date despite negative earnings revisions across the board



Source: Bloomberg as of 12 Apr 2024.

FIGURE 14: Investors in Chinese equities are likely to favor high dividend yielders versus high growth



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