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# China's Grand Reopening: The Nontraditional Recovery

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It has been more than three months since China's sudden reversal of its zero-COVID policy. China's reopening has been a highlight of global markets contending with fast-paced rate hikes and persistent inflation. However, how sustainable is China's recovery, and what risks does it face? We assess the likelihood that China's policy stance and structural constraints can support the nascent recovery, the impact on asset valuations, and investment implications.

## Despite Initial Fanfare, Recovery May Not Be as Expected

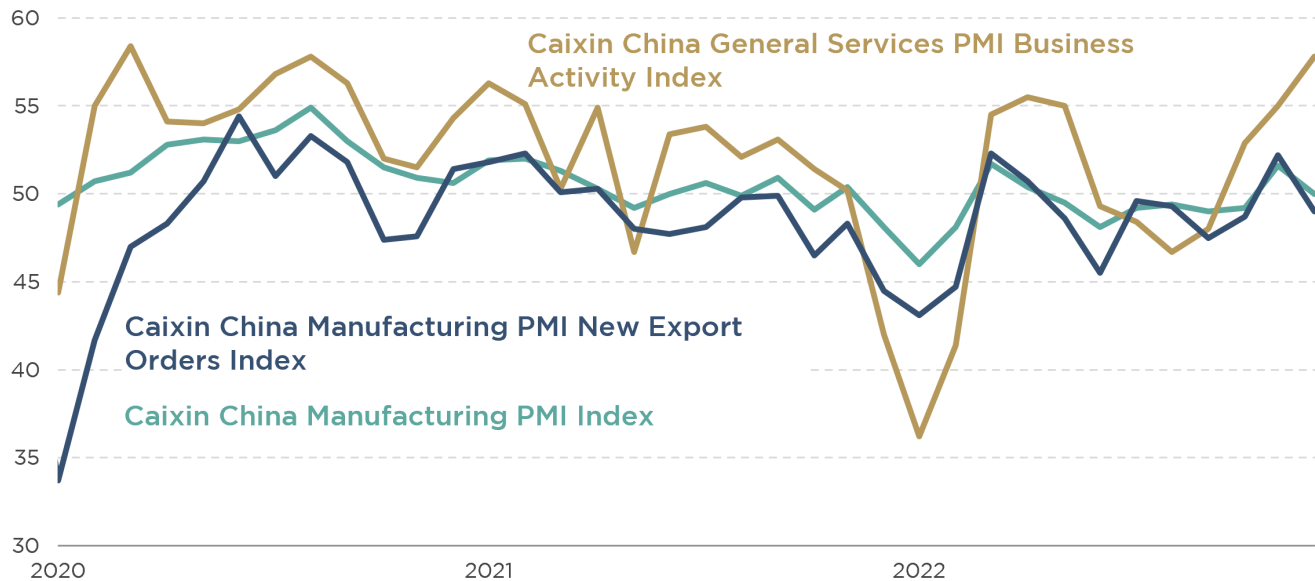
China's economic recovery is uneven, constrained, and at an early stage. There are unique characteristics of this recovery that will have a major impact on the global economy:

- Compared to previous recoveries, this recovery is driven more by consumption than industrial production, property, or manufacturing investments, evidenced by the outperformance of services PMI over manufacturing PMI (see [Exhibit 1](#)).<sup>1</sup> Services were more negatively impacted by zero-COVID policy than manufacturing and are subsequently seeing a larger rebound due to renewed mobility and the release of pent-up demand. However, while strong, it still pales when compared to the post-reopening consumer spending seen in the West, due to the lack of stimulus to households, impact of lockdowns, weak job market, and lower income growth.
  - Exports are still chugging along, but weak manufacturing PMI and weaker demand from developed countries that face looming recessions do not bode well for China's export orders. Recently, new export order PMI turned contractionary.
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## Caixin China Manufacturing PMI, Services PMI, and Export Orders PMI

Index, Seasonally adjusted, As of 4/7/2023

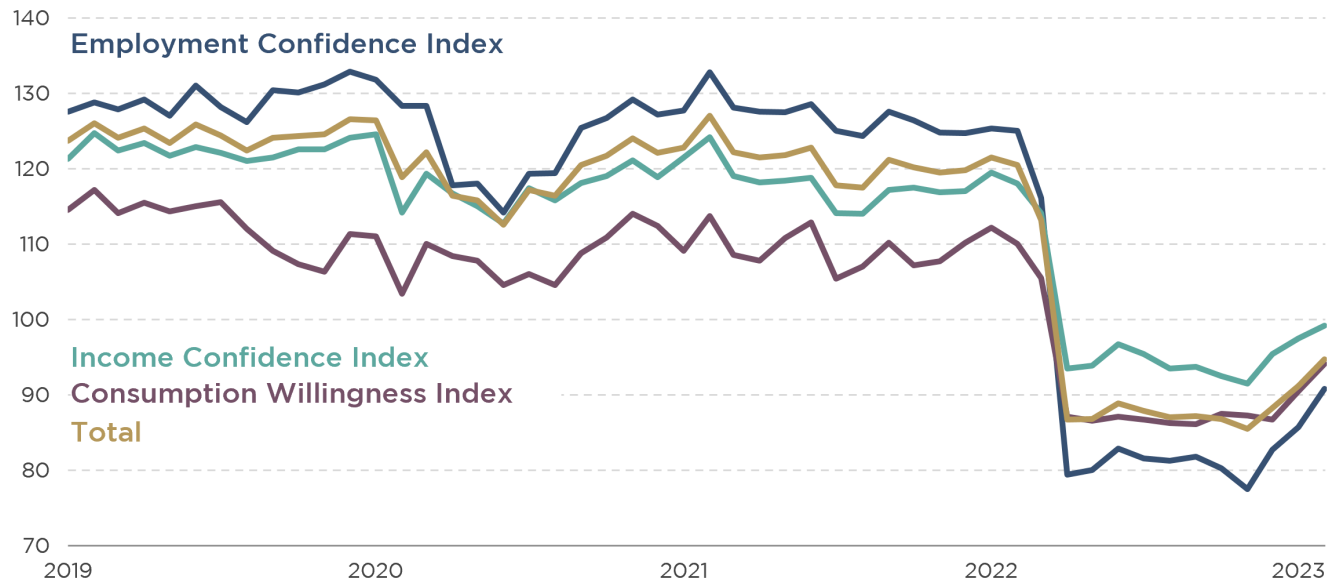


Source: Bloomberg (© 2023, Bloomberg Finance LP)

- The slight pickup in credit impulse has been driven mostly by state-owned enterprise (SOE) investment in infrastructure rather than private sector capex investment or household credit expansion. Consumer confidence is gradually recovering but is still fragile and low (see [Exhibit 2](#)).<sup>2</sup>

## China Consumer Confidence Index

Index, As of 2/1/2023



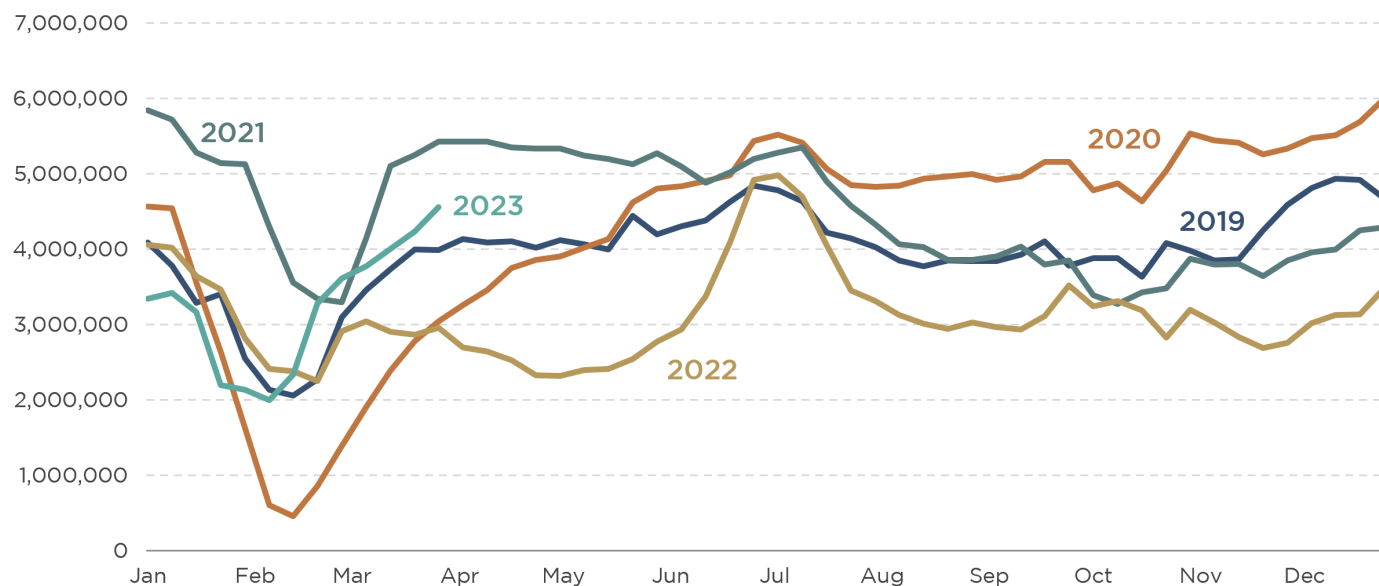
Source: Macrobond (© 2023, Macrobond)

- ▣ Mobility indicators continue to see steady improvement, but the recovery remains less than inflationary. Subway ridership, catering, and movie box offices all returned to pre-COVID levels. Retail sales growth is exceeding 10% in April, beating pre-COVID levels. Domestic flights have mostly normalized, but international flights are still in the early stage of recovery. The Ministry of Culture and Tourism expects Chinese tourists to take 4.6bn domestic trips in 2023, which is 75.8% of the 2019 levels.
- ▣ Industrial production year-to-date growth disappointed at 3.0% in March, reflecting continued headwinds to industrial activity. A domestic infrastructure push should benefit SOEs and basic materials, but external demand remains a concern given China's export outlook.
- ▣ Reopening and easier policy measures have lifted property sales and prices since the Chinese New Year (see [Exhibit 3](#)). However, several signs suggest the rebound may be short-lived. Lack of buyer confidence in the delivery of new homes may suppress pre-sales; April's property transactions have weakened; developer finances also remain weak; and a mortgage repayment wave indicates deleveraging amid weak household confidence. Property investments, however, will be less of a drag this year, but will still be contracting (see [Exhibit 4](#)). In addition, property inventory is elevated, especially in lower-tier cities.

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## China Weekly Property Sales

As of 4/16/2023

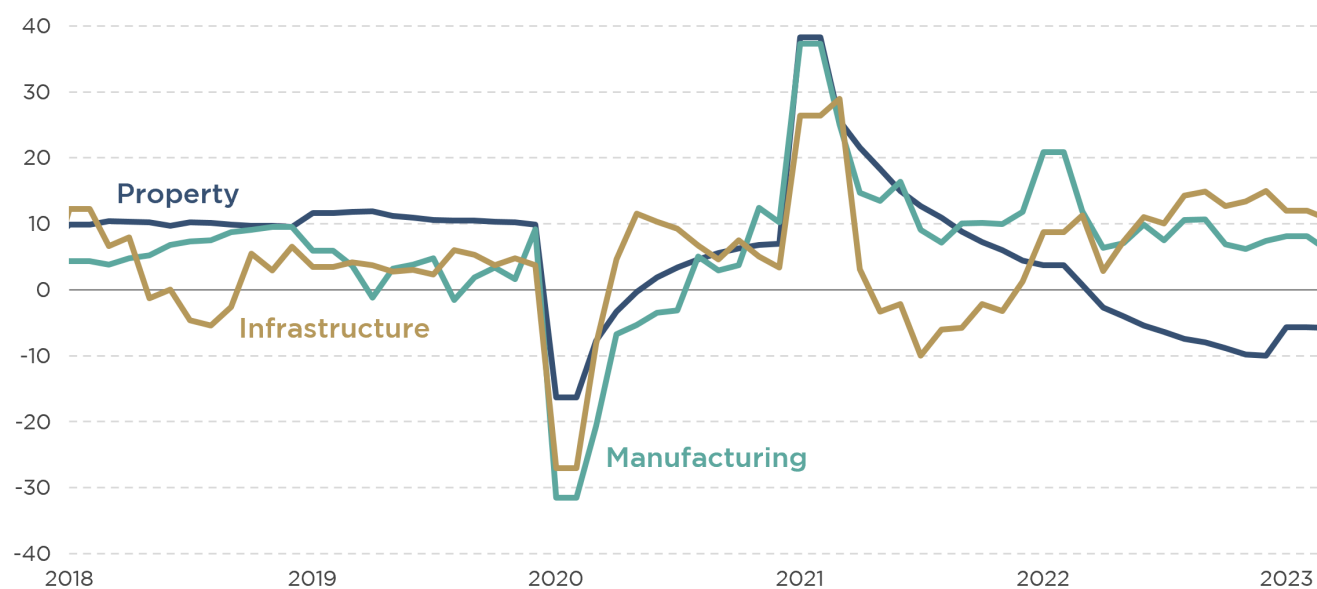


Source: Macrobond (© 2023, Macrobond)

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## China: Fixed Asset Investment Drivers

Year-over-year %, As of 3/1/2023



Source: Macrobond (© 2023, Macrobond)

With the initial reopening euphoria subsiding, the mixed data and muted indicators make us cautiously

optimistic over the strength and sustainability of China's recovery in the second half of this year.

## Recent NPC Meeting Focused on Moderate, Non-Inflationary Growth, Institutional Reform, and Risk Mitigation

President Xi's third term started with a new team focused on growth and support for private sectors with the aim of attracting foreign investors and restoring business confidence. Retainment of the incumbent People's Bank of China (PBOC) governor and finance minister signals policy continuity and a pragmatic approach.

The lower growth target of "around 5%" may leave some room for upside surprise but also indicates China's slower trend growth. Institutional reform was the central platform of the NPC meeting, with newly created layers of central commissions to strengthen party guidance over finance, technology, and society. No major stimulus was announced but fiscal deficits were set moderately higher. Monetary policy remains somewhat easy with reserve requirement ratio (RRR) cuts used to release long-term liquidity to support growth. In the property market, policymakers pledged to "promote the steady development" while resolving large developers' risk and focusing on risk management instead of a major easing. Local government debt risks were highlighted, and steps may potentially be taken to mitigate risks.

Overall, the Chinese government appears to prefer an organic growth rebound to prevent a similar inflation problem seen mostly in developed market countries.

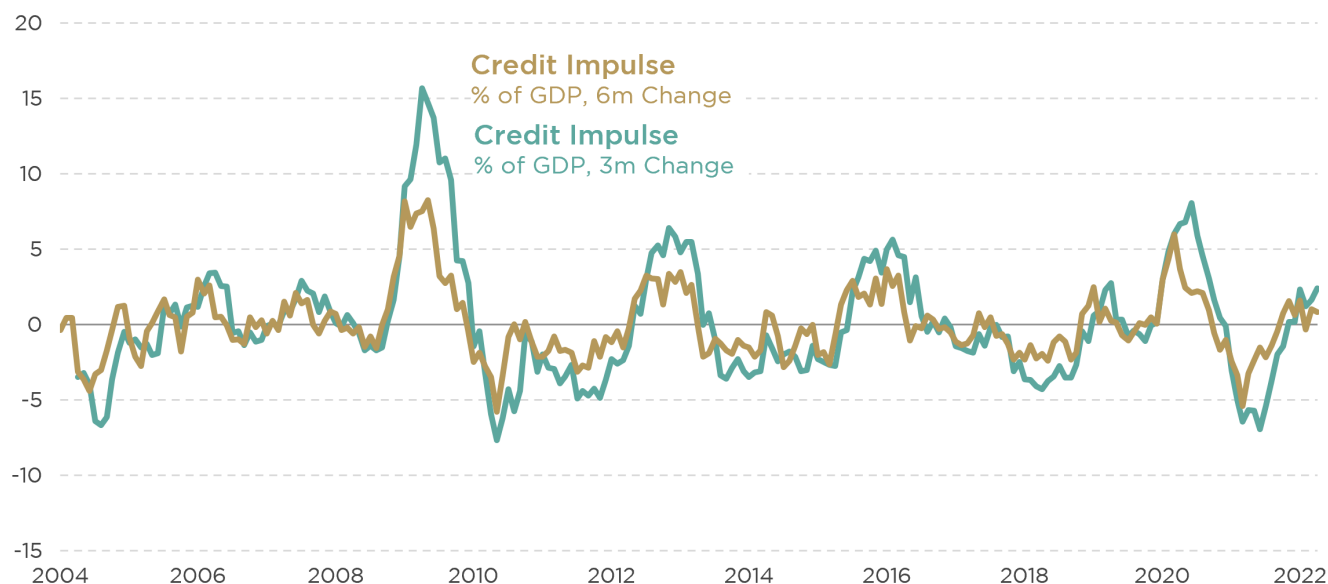
## Beyond Initial Reopening, Major Risks Remain for the Chinese Economy

We see four risks ahead for the Chinese economy:

- Gross domestic product (GDP) growth will likely accelerate through the second quarter as the base effects become more supportive. However, will the recovery be sustainable into the second half of 2023 without major fiscal stimulus and with the residual effects from zero-COVID? While the credit impulse is picking up (see [Exhibit 5](#)), household loan growth has stayed low whereas corporate loans have rebounded the most due to SOE loans. Internally, the test for the recovery's sustainability will be whether the labor market and private sector credit demand, driven by investment, improve. Externally, the determining factor would be whether we start to see strong export demand.
  - Domestic policy remains uncertain. Will there be more regulatory crackdown on the financial and tech sectors?
  - Heightened geopolitical tensions are perhaps the most significant risks, led by the possibility of further deterioration in the U.S.-China relationship. The semiconductor chip export ban from the U.S. along with the Netherlands and Japan will hinder China's growth further.
  - Local government financing vehicle (LGFV) risks are rising as China's provinces are more susceptible to debt-refinancing pressure due to weak fiscal revenue and higher borrowing costs. Potentially, there might be a restructuring of local government debt and asset sales.
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## China Credit Impulse

%, 3-Month and 6-Month rate-of-change basis, As of 3/1/2022



Source: Macrobond (© 2023, Macrobond)

## Outlook for China-related Assets

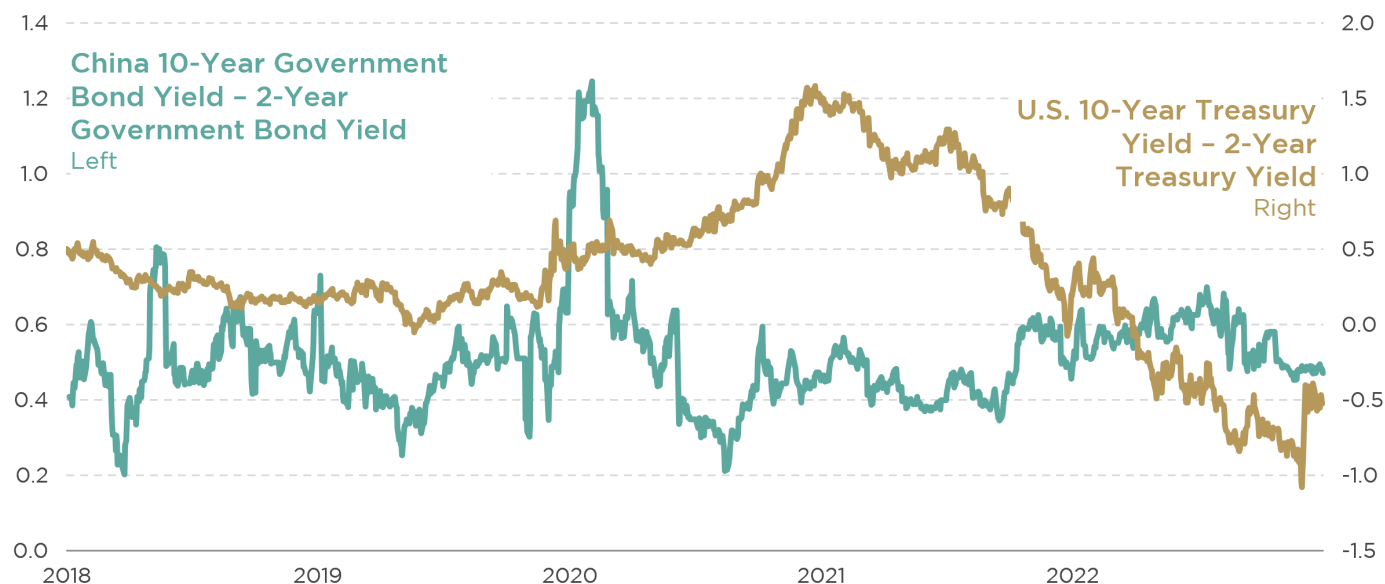
The initial euphoria in asset markets has faded surprisingly quickly. Chinese onshore bonds, the yuan (CNY), and Chinese equities have largely retraced their gains since the beginning of the year. How high asset prices can rise depends on the strength of the Chinese economy going forward.

China 10-year bond yields initially sold off but have rallied since the Chinese New Year as the reopening trade stalled. The 2-year/10-year yield curve flattened by about 20 basis points (bps) during the same time period (see [Exhibit 6](#)). Such a flat curve could preclude a further yield rally on the long-end without short-end rates rallying sharply. Monthly foreign flows into the onshore bond markets reversed back to outflows, signaling the cautious attitude of global investors (see [Exhibit 7](#)). We do not see a catalyst to trigger a sovereign bond rally from here, especially with a negative 44bps interest rate differential between Chinese and U.S. benchmark 10-year bonds.

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## Yield Curve Comparison

%, As of 4/7/2023

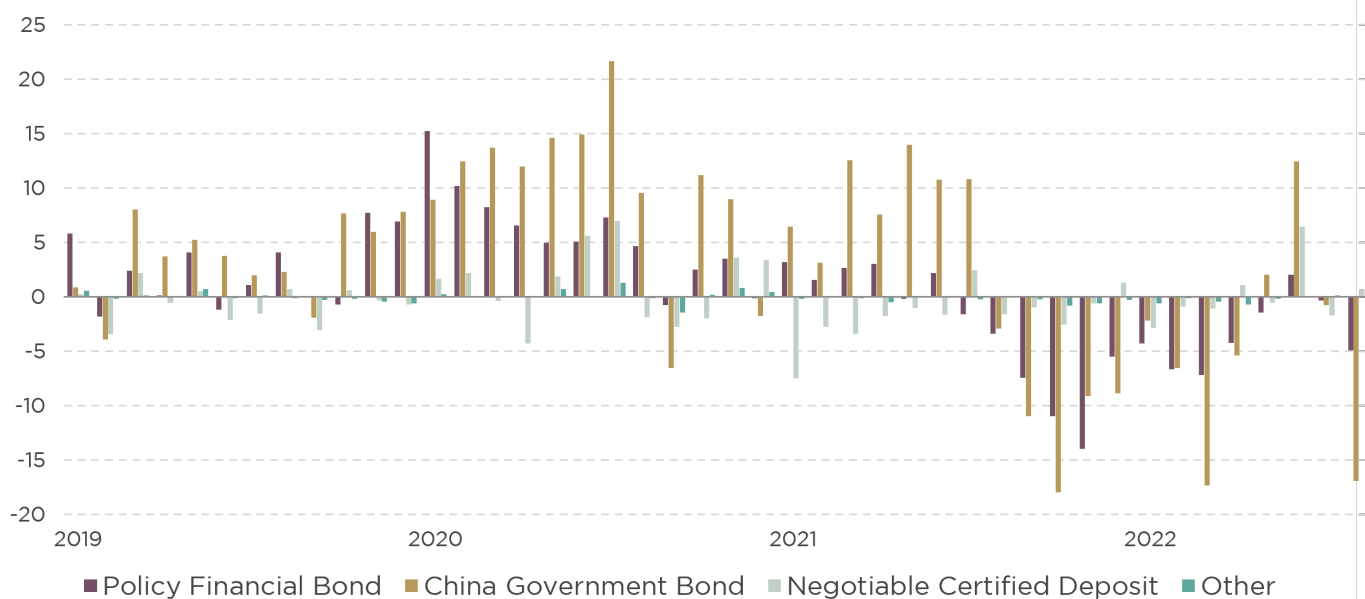


Source: Bloomberg (© 2023, Bloomberg Finance LP)

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## Change in Foreign Ownership

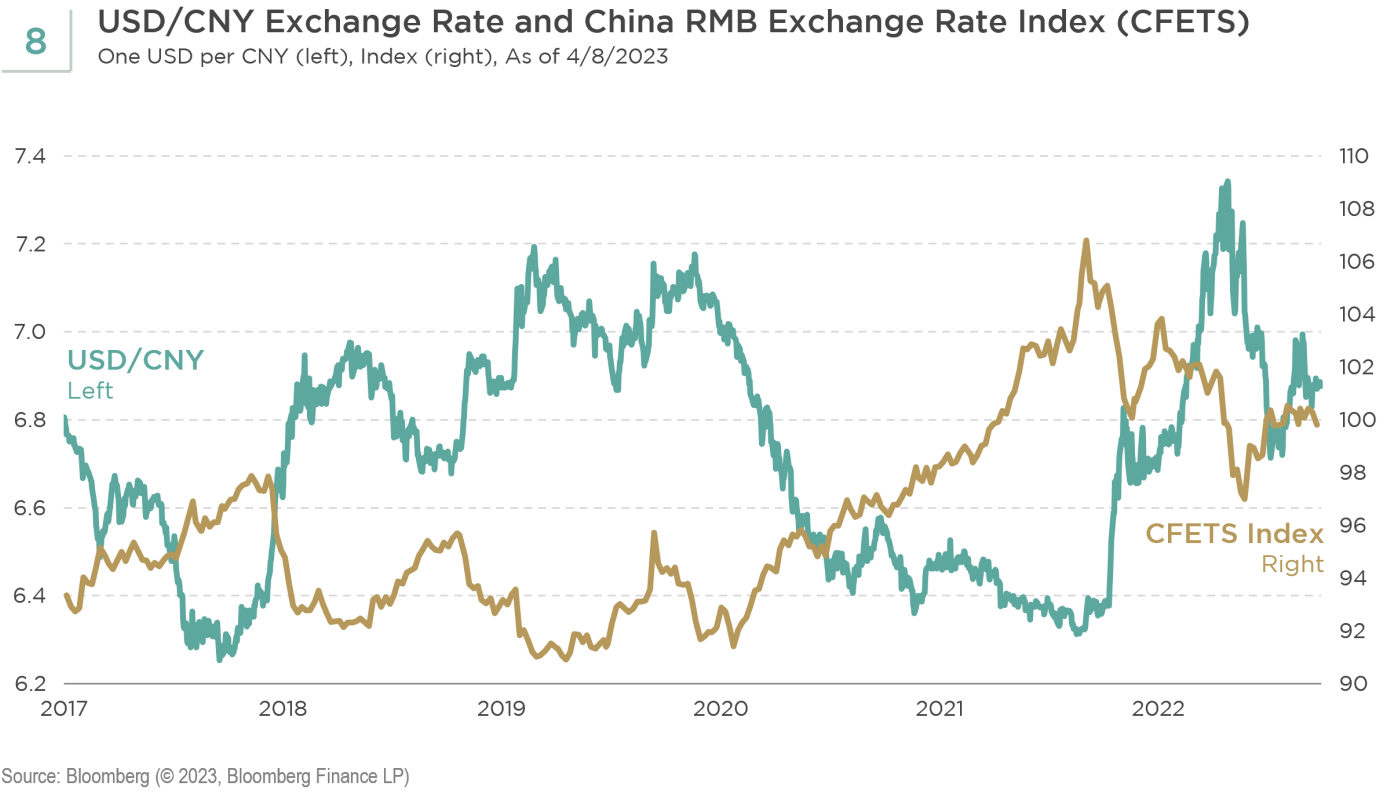
USD bn, As of 2/1/2023



Source: Macrobond (© 2023, Macrobond)

The CNY has benefited from a weaker U.S. dollar (USD) as markets repriced the looming end of the Fed's hiking

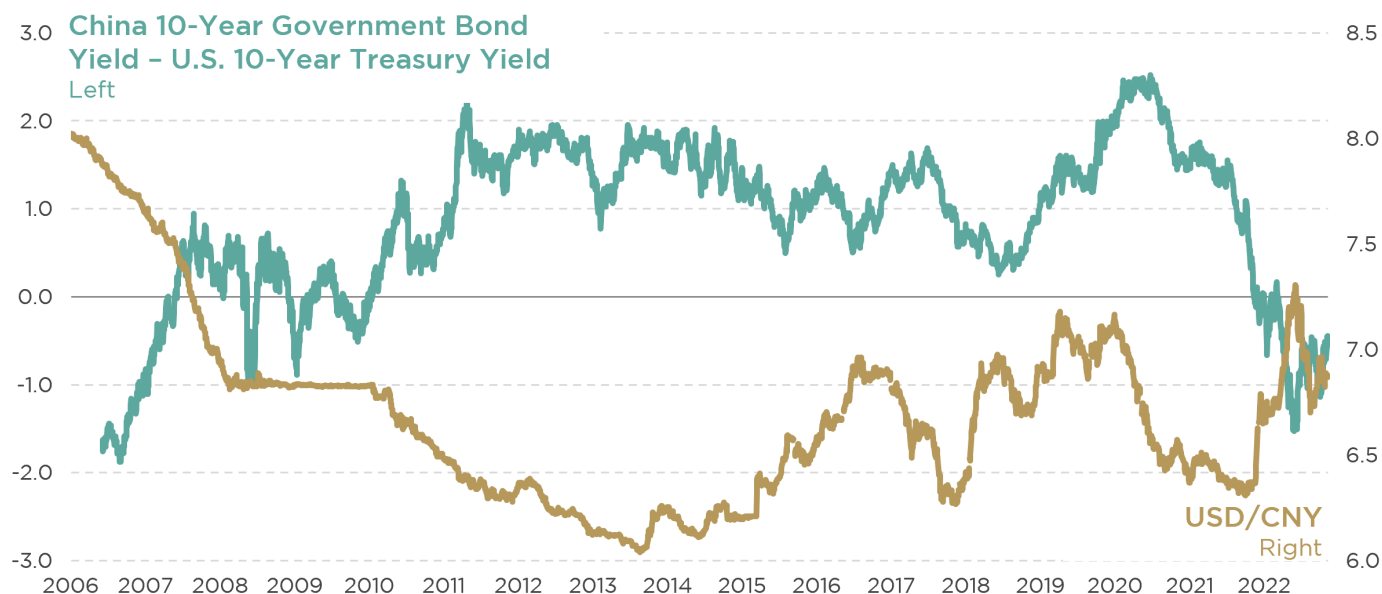
cycle and potential rate cuts in the U.S. However, China’s currency has remained somewhat flat since the beginning of this year (see [Exhibit 8](#)).<sup>3</sup> Interest rate differentials indicate the exchange rate could return to the one USD to 7.4 Chinese yuan (CNY) level, which suggests CNY is rich versus USD (see [Exhibit 9](#)). However, we do not see much pricing anomaly in the CNY.





## USD/CNY Exchange Rate and 10-Year Bond Interest Rate Differential

% (left), One USD per CNY (right), As of 4/7/2023



Source: Bloomberg (© 2023, Bloomberg Finance LP)

## Conclusion and Investment Implications

Compared to reopenings in other countries, China's recovery was expected to be especially robust. The abrupt removal of zero-COVID restrictions was predicted to unleash a torrent of economic growth. However, the initial market euphoria has given way to an uneven and restrained rebound due to structural constraints.

Despite still-low consumer confidence, consumption is driving the recovery rather than China's old property-led business recovery. This shift may result in less demand for commodities compared to previous cycles. The sustainability of this recovery remains questionable, given China's limited fiscal stimulus, potentially weak property market recovery, and lingering social effects from stringent zero-COVID policies. We believe a stronger and sustained rebound remains contingent on job market improvement, an uptick in confidence in the private sector, and continuing external global demand. China also faces various structural growth and policy constraints. One is the ongoing need to defuse financial risks in the property sector and LGFV sectors. Others include addressing changing demographics, developing technology self-sufficiency, and ensuring national security in an adverse geopolitical environment.

We conclude with four major implications on the investment landscape from China's uneven economic recovery:

- ▣ Support for global growth might be limited in the second half of 2023.
- ▣ Support for commodity-dependent emerging market (EM) risk assets might be less powerful than previous cycles.
- ▣ The expected return of Chinese tourism to destination countries, especially in Asia, should be strong but has yet to play out fully.
- ▣ Some EM countries may benefit from reshoring supply chains out of China. Mexico, Malaysia, and Vietnam are cases in point.

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## Index Definitions

**1 Chart 1: The Caixin China Manufacturing PMI is a composite indicator designed to provide an overall view of activity in the manufacturing sector and is derived from a survey of around 650 private and state-owned industrial companies. The Manufacturing Purchasing Managers Index is a weighted average based on five individual indexes with the following weights: New Orders (30 percent), Output (25 percent), Employment (20 percent), Suppliers' Delivery Times (15 percent) and Stocks of Items Purchased (10 percent), with the Delivery Times index inverted so that it moves in a comparable direction. The Caixin China Manufacturing PMI New Exports Orders Index is an individual index within the Manufacturing PMI Index measuring changes in the volume of new export orders from the prior month. The Caixin China General Services PMI Business Activity Index is a diffusion index compiled from questionnaires sent to a panel of purchasing managers from approximately 650 private and state-owned services companies. The index measures changes in the volume of business activity compared with the prior month.**

**2 Chart 2: China's National Bureau of Statistics produces the China Consumer Confidence Index, which is based on a poll of 700 individuals over 15 years old from 20 cities across the country. The index assesses consumer confidence in China on a scale of 0 to 200, with 200 indicating extreme optimism, 0 suggesting extreme pessimism, and 100 denoting neutrality. The consumer survey contains standardized questions about the financial situation of households, general economic situation, inflation, unemployment, saving, intentions of making major purchases on durable goods or purchasing or building a home or buying a car. The Employment Confidence Index indicates the level of confidence in employment. The Income Confidence Index indicates the level of confidence in income. The Consumption Willingness Index indicates survey respondents' willingness to consume.**

**3 Chart 8: CFETS RMB Index refers to a currency basket that includes the 13 currencies listed and directly trading against the renminbi (RMB) in CFETS (China Foreign Exchange Trade System). The sample currency weight is calculated by international trade weight with adjustments of re-export trade factors.**

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