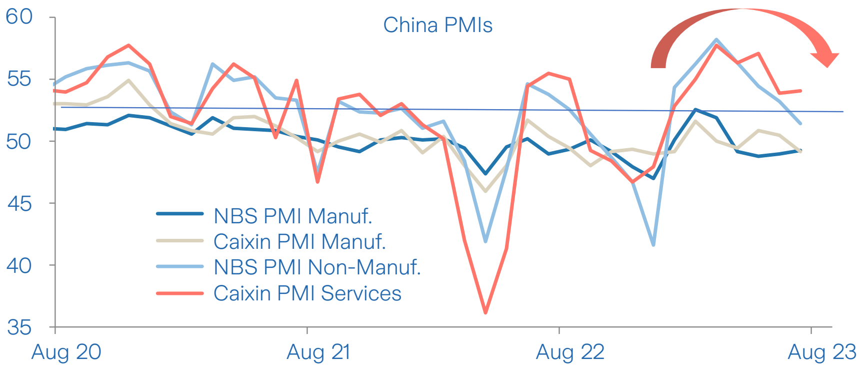
ZURICH

Topical Thoughts
August 2023

China: Will the ailing economy be bolstered?

Global investors appear to believe that China is facing a crisis of confidence, both internally and externally. Domestic consumers and investors have learnt that property investments will not guarantee ever rising wealth and that China's social safety net has gaps. Meanwhile, some of China's foreign trading partners and investors are starting to diversify supply chains towards other countries and regions like India or the Association of Southeast Asian Nations (ASEAN).

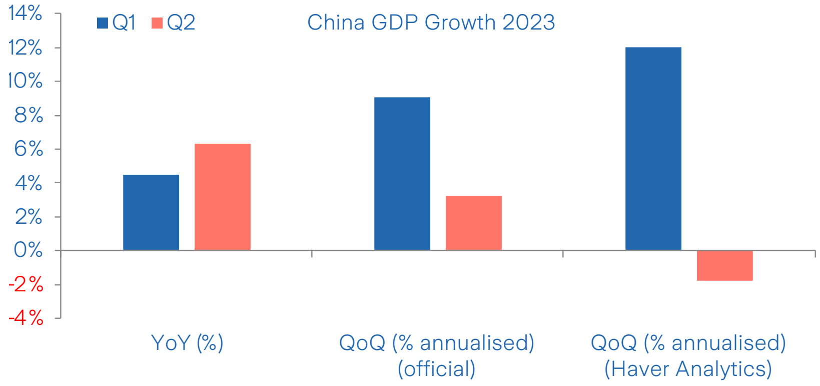
China's reopening in December 2022, after giving up its strict zero-Covid regime, came as a surprise. While many observers had expected a prolonged slump in economic activity due to a rapid surge in Covid infections, the release of pent-up demand ignited a consumption and travel boom as well as solid demand for new homes. Economists rushed to revise their annual growth forecasts significantly higher, assuming that a new 'gold rush' had started. However, despite solid activity data for about two months, the boom quickly subsided. Most economic activity data for April, May and June came in far weaker than consensus had expected and high frequency data for July also fail to show a reversal.



Source: NBS, Caixin, Bloomberg
Note: PMI = Purchasing Manager Index

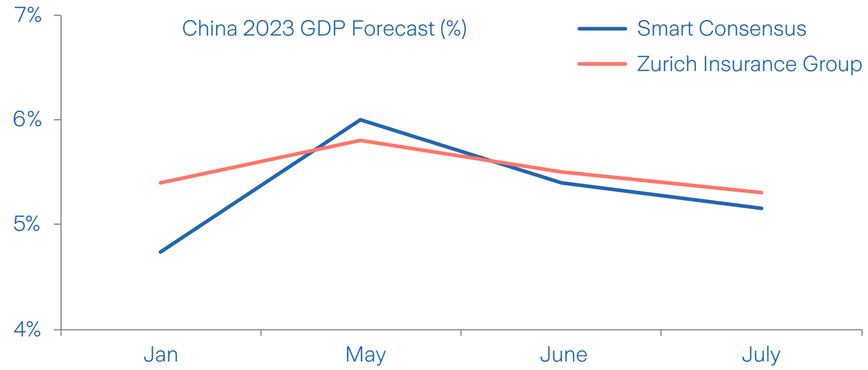
GDP statistics reveal mixed messages. In YoY terms, growth improved from 4.5% in Q1 2023 to 6.3% in Q2 2023. At a first glance, this appears to be an improvement and was highlighted as such by Premier Li Qiang at the latest Davos Forum in Tianjin in June. We are more cautious. Firstly, the outcome was worse than what consensus, at 7%, had expected. More importantly, however, is the fact that the YoY comparison is distorted. Q2 2022 was negatively impacted by Covid related lockdowns in Shanghai and other major cities, causing a severe drop in economic activity, and thus a lower base for YoY comparisons. In contrast, growth slowed rapidly on an annualised sequential basis. As is often the case, Chinese statistics can be distorted, but it is clear that the economy is struggling and, in marked contrast to other parts of the world, deflationary trends are visible.

Front cover image source: iStock



Source: NBS, Haver Analytics, Bloomberg

Some commentators now believe that China will fail to achieve its growth target this year. We are less pessimistic, even though we have revised down our growth forecast for this year and now expect real GDP growth of 5.3% YoY, which is tilted towards the upper end of the government's target of 'around' 5%. However, we suspect that the government's official target is rather conservative in order to make sure that it can be met following last year's miss, which occurred following the massive Covid lockdowns. We also note that the weighted average of regional forecasts by China's provinces is above the national 5% target.

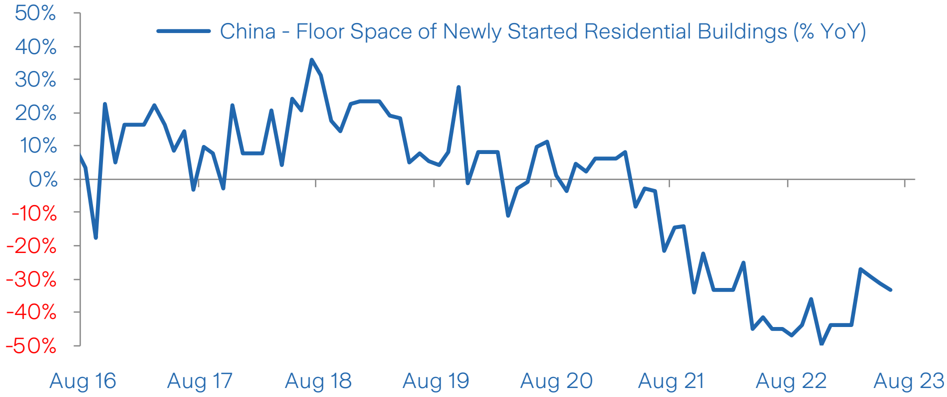


Sources: Consensus Economics, Zurich Insurance Group
Note: 'Smart' consensus depicts ten prominent investment advice and research providers

Most of the individual statistics for June came in below consensus expectations and confirm a further, rather broad-based slowdown in economic activity. The property sector continues to be at the core of falling consumer confidence. Property investments contracted amid declining new housing starts and property sales, while the number of cities experiencing lower home prices increased. Overall, according to the NBS 70-cities data released by the National Bureau of Statistics, new home prices declined marginally on average, though the differences across various cities are masked. Meanwhile, secondary home prices fell both in sequential and YoY terms across all city tiers. This is a major concern for the government as property represents around one third of China's economy.

Major property companies are now being urged by the authorities to focus on completing unfinished residential construction following the social unrest last year. As these projects have already mostly been paid for by the purchasers, property companies are receiving less new cash and are refraining from rushing completion or investing into new land banks for future projects accordingly.

As property is the main asset of most residents, comprising about 60% of private wealth, changes in its value have a significant impact on overall consumer confidence. Property is perceived as a 'store of wealth', and it is assumed that as such it increases in value over time. Should that not be the case, falling property prices or delays in housing completions can lead to violent protests against property developers, as happened last year. At a minimum, it will have a negative impact on sentiment, curtailing housing demand and goods consumption. Indeed, the value of new home sales fell 25.1% YoY in June, while new home starts (floor space) were down 33.5% YoY.



Source: Bloomberg Intelligence

But that is not the only drag on consumer confidence. Consumers experienced tough times during Covid related lockdowns, unable to leave their homes and, unlike in the US and Europe, receiving no compensation for their hardship. This experience, and the current economic uncertainties, have pushed up the savings ratio, as consumers have realised that the social net is small in comparison to other countries. Meanwhile, the rising debt-service burden is causing more headaches. Barclays Investment Bank estimates that the debt-service ratio has surged from 8% to 22% within the last 15 years, far above levels in the 5-10% bracket seen in Japan, the US and major European countries.

Household income for employees in various private industries and public agencies has been stagnating or even shrinking amid compensation cuts particularly amongst tech, finance and public services employers. While labour market conditions appear to be stable, with the unemployment rate hovering at 5.2% for the third month in a row, the youth unemployment rate in the age bracket 16-24 years has risen to a record high of 21.3% in June, which negatively impacts consumer confidence also for their parents.

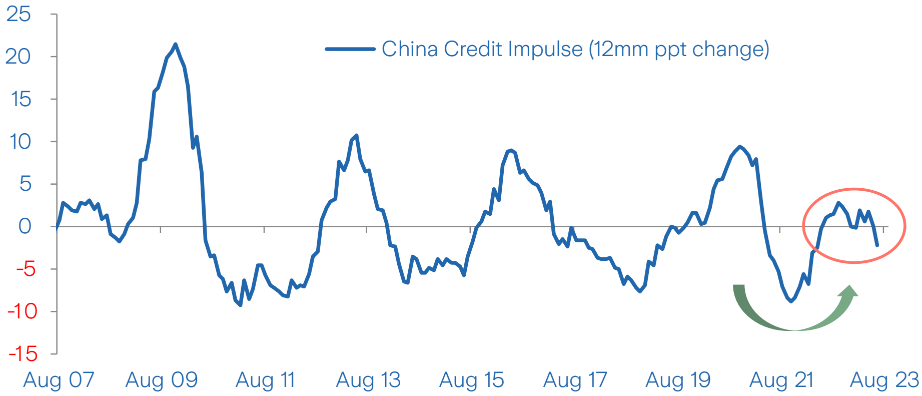
Cautious consumer sentiment is reflected in soft retail sales growth, though there are differences amongst categories. While expenditures in restaurants as well as for medicine, personal care, electric appliances and outdoor activities are growing steadily, those in categories related to housing such as furniture and decoration remain soft. Consequently, the desire and need to move China to a consumption rather than an industrial economy is faltering at a time when the country can least afford it.

Meanwhile, following a significant drop in April, industrial production stabilised in May and rose slightly in June. The picture remains mixed for fixed asset investments, with solid infrastructure and manufacturing investment growth following public support measures, while property investments continue to struggle, down more than 10% YoY.

The foreign trade situation and outlook are not promising either. Both June and July exports fell more than consensus had expected, marking the biggest decline since the pandemic started, as depressed global goods demand from the US, Europe, Japan, Korea, Taiwan and ASEAN are negatively impacting Chinese exporters. Apart from a few stronger segments like EV-cars, batteries, solar panels and mobile phones the outlook for the rest of this year is not promising amid rapidly falling new export orders. Consequently, China can no longer rely on exporting itself to prosperity. Meanwhile, the bigger than expected drop in July imports confirms weakness in domestic demand, falling commodity prices and the fact that more countries are extending high-tech export restrictions to China.

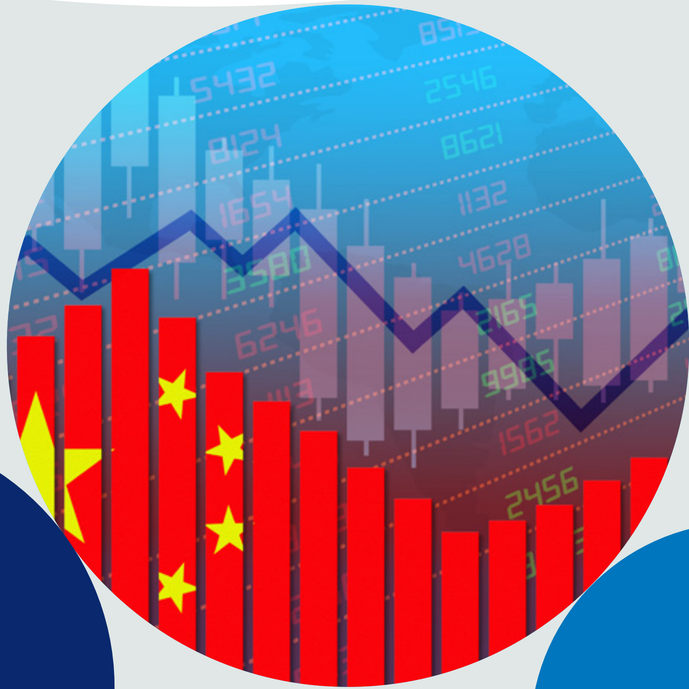
Looking forward, bank lending and credit data will be critical. At first glance, June data came in favourably above consensus expectations, but we are disappointed by the weakness in broad aggregate financing. While the absolute numbers may seem to be solid, we prefer to look at the YoY rate of change to smooth seasonal distortions, which fell to a lacklustre 9% YoY in June. Government bond issuance rose, but was offset by falling corporate bond issuance, which is a reflection of private sector investment intentions.

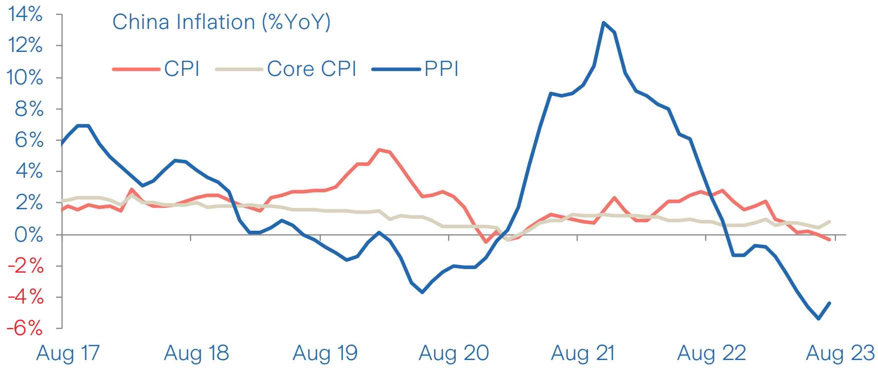
The credit impulse, defined as the new lending over GDP increment, has fallen back into negative territory, which is rather unusual at the current stage of the cycle. Looking at previous cycles after 2008, the credit impulse continued to recover once it had moved into positive territory, as the chart shows. The latest recovery was weak, and now seems to have already peaked and moved back to negative territory. It is too early to tell whether it will fall back to prior lows, or whether the latest move is just an interruption on the way up, but we have some concerns amid the fact that the credit impulse had weakened at such an early stage in the recovery.



Source: Bloomberg, Zurich insurance Group
Note: Credit impulse measures the acceleration of credit versus GDP growth

Consumer prices joined producer prices in deflationary territory in July, slipping to -0.4% YoY, with producer prices down -4.4% YoY, which is surprising amid global inflationary threats. The CPI drop was mainly caused by base effects in food price inflation while services inflation rose to a 17-month high of 1.2% YoY. Core CPI inflation rose to 0.8% YoY. Price declines are taking their toll by pushing up real interest rates, which is another headwind for economic growth and financing conditions. However, we suspect that broader price deflation will not persist for too long.

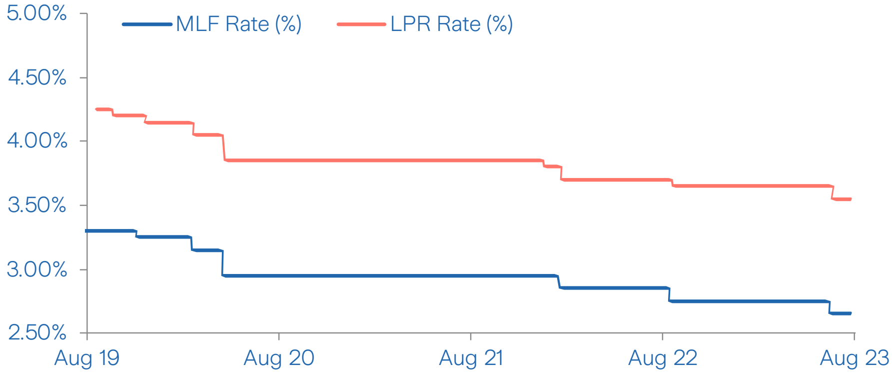




Source: NBS, Bloomberg

The government is fully aware that the overall gloomy state of China's economy requires swift policy support, as the measures announced by the Communist Party's Politburo following its July 24 meeting confirm. Investors approved, as visible in the 5.3% 'H'-share rally following the meeting, even though the measures outlined are rather modest and targeted. Five notable areas of support we see are:

- Monetary policy is likely to be eased further in 10bps steps into early 2024, with further mortgage rate cuts for both new and existing housing loans as well as a 25bp RRR cut.



Source: PBoC
Note: MLF = 1-year Medium-term Lending Facility, LPR = 1-year Loan Prime Rate

- Though a major fiscal boost is unlikely, various measures have been discussed, such as additional special bond issuance by local governments and hastening central government investment programs. Policy banks are likely to play a bigger role in supporting infrastructure projects, particularly for environmentally friendly investments.
- In terms of housing related policy, one focus will be on speeding up the supply of affordable housing and the renovation of 'urban villages'. Easing of mortgage access and a reduction of Housing Purchase Restrictions (HPR), particularly in bigger cities, has also been put on the agenda. We note that Xi Jinping's slogan 'Housing is for living, not for speculation' was not mentioned, which does not suggest that speculative investing is now welcome, but that financing restrictions are likely to be eased.
- The Politburo highlighted the importance of the private sector, providing proper market access and protecting property rights.
- Consumption is another field that has been highlighted by supporting measures to boost purchases of electric vehicles, electronic and household goods, and services including tourism, sports and leisure.

While many investors had been eagerly awaiting the outcome of the Politburo meeting, other support packages were already announced in June, including the 31 measures to spur the private sector, announced by the Central Committee and the State Council, and a program to boost consumption announced by the National Development and Reform Commission (NDRC).

When analysing the 31 measures, our overall impression is that some of these are meant to repair the damage that has been caused over the last three years, when major internet platforms and gaming companies were hit by antitrust measures, major IPOs were cancelled, the private tutorial sector was forced to turn non-profit while restricting the employment of foreign teachers, and funding support for private real estate developers was withdrawn. Now the new measures focus on topics like strengthening legal protection, increasing policy support, promoting healthy growth and high-quality development, respecting innovation and entrepreneurship, improving the relationship between the public and private sector, promoting private R&D investments and employment expansion by platform companies.

Meanwhile, China has moved to the policy rollout phase. As the Politburo has issued broad guidelines, other public entities are now following up with more detailed measures. For example, the Minister of Housing and Urban-Rural Development (MoHURD) pledged to lift restrictions on home purchases and implement specific support measures in major cities in order to boost local housing demand.

We believe China's government has learned from both over-stimulating the economy following the Lehman Crisis, and then over-regulating entrepreneurship. To us, the prime focus will be on whether the measures announced will ignite confidence among households, companies, trading partners and investors. We believe the annual growth target is achievable and can re-energise the stumbling economy if the support package is implemented quickly and efficiently.

Disclaimer and cautionary statement

This publication has been prepared by Zurich Insurance Group Ltd and the opinions expressed therein are those of Zurich Insurance Group Ltd as of the date of writing and are subject to change without notice.

This publication has been produced solely for informational purposes. The analysis contained and opinions expressed herein are based on numerous assumptions concerning anticipated results that are inherently subject to significant economic, competitive, and other uncertainties and contingencies. Different assumptions could result in materially different conclusions. All information contained in this publication have been compiled and obtained from sources believed to be reliable and credible but no representation or warranty, express or implied, is made by Zurich Insurance Group Ltd or any of its subsidiaries (the 'Group') as to their accuracy or completeness.

Opinions expressed and analyses contained herein might differ from or be contrary to those expressed by other Group functions or contained in other documents of the Group, as a result of using different assumptions and/or criteria.

The Group may buy, sell, cover or otherwise change the nature, form or amount of its investments, including any investments identified in this publication, without further notice for any reason.

This publication is not intended to be legal, underwriting, financial investment or any other type of professional advice. No content in this publication constitutes a recommendation that any particular investment, security, transaction or investment strategy is suitable for any specific person. The content in this publication is not designed to meet any one's personal situation. The Group hereby disclaims any duty to update any information in this publication.

Persons requiring advice should consult an independent adviser (the Group does not provide investment or personalised advice).

The Group disclaims any and all liability whatsoever resulting from the use of or reliance of this publication. Certain statements in this publication are forward-looking statements, including, but not limited to, statements that are predictions of or indicate future events, trends, plans, developments or objectives. Undue reliance should not be placed on such statements because, by their nature, they are subject to known and unknown risks and uncertainties and can be affected by other factors that could cause actual results, developments and plans and objectives to differ materially from those expressed or implied in the forward-looking statements.

The subject matter of this publication is also not tied to any specific insurance product nor will it ensure coverage under any insurance policy.

Zurich Insurance Company Ltd
Group Investment Management
Mythenquai 2
8002 Zurich

P0580618 (08/23) TCL

ZURICH