INVESTMENT REPORT

China past its peak

After a brief rebound, long term risks will remain

Rathbones

Content

Foreword

Not so long ago it was thought inevitable that China would soon surpass the US to become the world's largest economy, and few would've questioned the notion. Many still see China as a place to invest for superior growth opportunities in comparison to the major developed markets. Yet we are already well over a decade into a structural slowdown in China's economy, and investors may have yet to fully account for China's diminished longer-term growth prospects.

It is likely to rebound strongly this year, following the scrapping of the zero-COVID restrictions and policy turning more supportive. Yet the longer-term challenges facing China haven't changed, and we think this cyclical rebound will eventually give way to structurally slower growth. On top of that, growing geopolitical tensions will make for an even tougher investment environment for foreign investors to navigate in China.

In our 2016 report **Taming the dragon,** we drew attention to a much lower growth outlook due to an ageing workforce, misallocated capital and excess debt, and a profound slowdown in productivity growth. We thought then that China's economy would grow at an average 5% annual rate over the next 10 years, compared to 10% a year over the previous decade.

We update our view in this report, concluding that this extended period of adjustment to a lower growth rate will continue after China's post-COVID bounce, and that will affect many of the markets and companies that import to and export from China. Here we set out some of the key implications of China's slowdown for global investors - we hope you enjoy reading this report and find it helpful.

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China past its peak

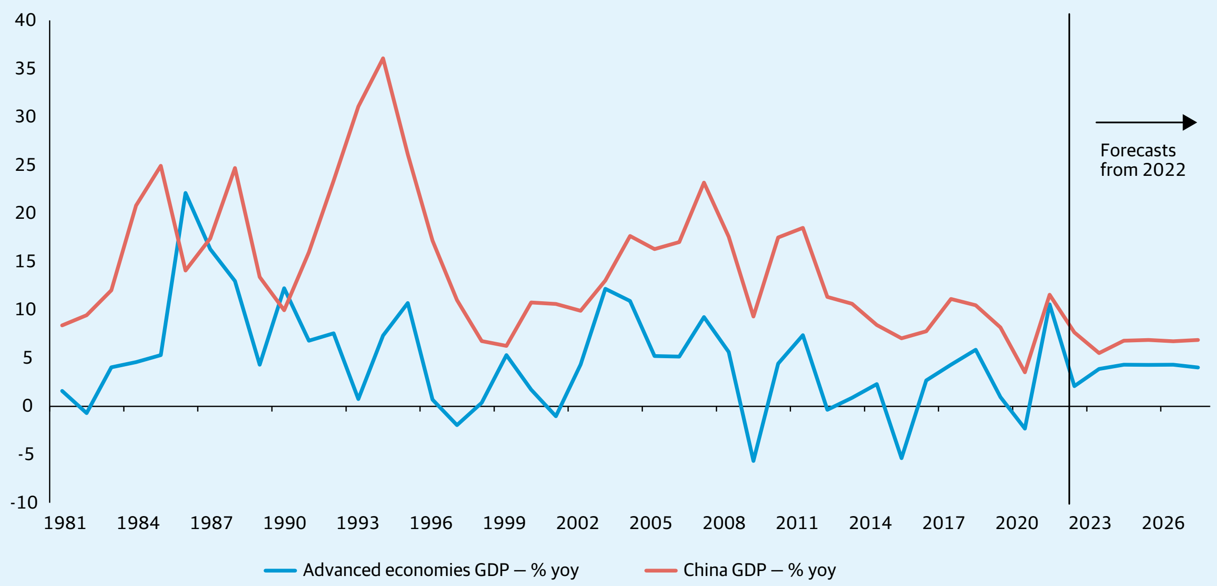
In for a bumpy ride

Following China's 'great reopening', growth is likely to accelerate this year. But we're sceptical that it will be as successful as many are currently assuming - to put it mildly, it seems unrealistic to think that you only get one month of bad disruption from opening up with minimal preparation after three years of effective lockdown and lower rates of vaccination than in the West.

We expect the road ahead to be bumpy, the same sawtooth pattern that characterised the first quarter or two in other economies that have reopened from COVID. Of course, there is plenty of pent-up demand for consumer services - social activities in particular - and policymakers are acting to stabilise the housing market. Both should help to lift growth in the near term, meaning this year looks much better than last.

Yet the longer-term challenges facing China haven't changed and this cyclical rebound is likely to give way to structurally slower growth as key pillars of China's growth model provide less support. The long-run average growth of China's economy is likely to be much closer to that of advanced economies in the coming decade than the rapid rates it experienced in the 2000s and much of the 2010s (see figure 1 below). With the investment environment also becoming harder to navigate, long-term investors should be wary of chasing the recent rally in Chinese assets.

Figure 1. China's growth versus advanced economies



Source: XXX (TBD)

The idea of a structural slowdown in China's economy should be nothing new - we're already well over a decade into it (see our 2016 report Taming the dragon). Growth in China peaked in 2007, and steadily fell (albeit from a very high level) through the 2010s, never matching the pace of the years just before the global financial crisis. This structural slowdown has coincided with a generally underwhelming period for China's equity markets, despite strong showings from a few tech firms. The performance of both the mainland and Hong Kong markets relative to developed markets peaked around the same time as economic growth, way back in 2007.

We believe this structural slowdown will continue after a cyclical rebound in 2023, and our analysis of what is reflected in market pricing suggests that investors may not have fully accounted for China's diminished longer-term growth prospects. Economists think of the long-term output of an economy as a function of the supply of labour, the supply of capital, and productivity (how efficiently labour and capital are deployed), so we've organised our reasons for expecting an ongoing structural slowdown in China under those same three pillars.

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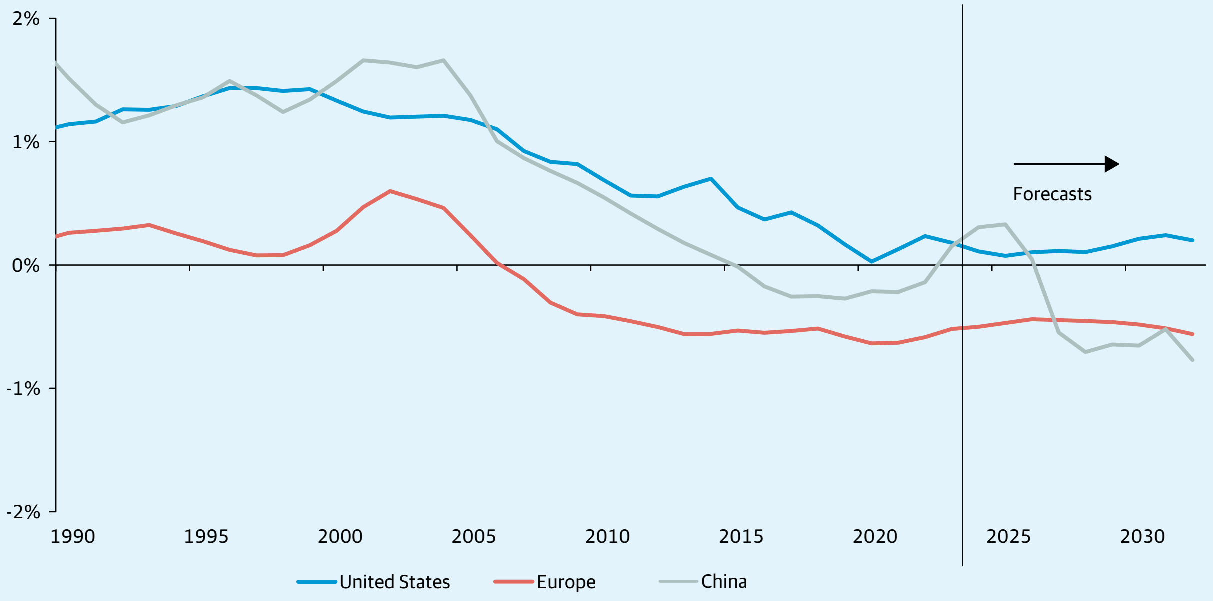
Labour supply

Swimming against the demographic tide

China's working-age population rose rapidly during its golden age of growth in the 2000s, but broadly stagnated in the 2010s and is now starting to decline. It is likely to contract more quickly as the decade goes on. The contrast with the largest advanced economies is unfavourable too. The working-age population in the US is likely to grow at a slow, steady rate, while the working-age population in Europe is likely to fall less quickly than in China, in contrast to the last decade (see figure 2).

The key reason demographics are becoming such a headwind in China is the prior drop in fertility/birth rates there. The government's efforts to address this via the end of the one-child policy in 2016 (and further relaxation of rules in 2021) have been unsuccessful so far, with the fertility rate dropping further, particularly during the pandemic. Even if policy change does eventually turn this trend around, it will take a very long time to make a difference, since children born this year won't be old enough to work until the late 2030s.

Figure 2. Working-age population annual growth and UN projections



Source: Refinitiv, Rathbones

China today finds itself in a situation analogous to Japan's in the early 1990s. The end of Japan's multi-decade "economic miracle" - which had seen it become the second-largest economy in the world - coincided with its working-age population peaking. Demographics have been a headwind there ever since. (Japan also had to deal with the consequences of an over-inflated property market - more on that in China's case later.)

While Japan has partly been able to offset its falling working-age population since then by increasing female labour force participation, there's less scope for China to do the same. The percentage of working-age women in the labour force in China today is around the same level as in the largest advanced economies (69% in China versus 68% in both the US and EU and 73% in Japan today). In contrast, it was less than 60% in early-1990s Japan.

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Capital

The limitations of China's investment-led model

China's growth model has long been enormously dependent on investment. Investment in capital as a share of GDP has been far higher than in other major economies (see figure 3). As a result, during the 2000s and 2010s China grew its capital stock at a breakneck pace, with few parallels in economic history. Yet there are clear reasons to doubt this will continue.

Such capital formation includes housebuilding, which until the current downturn grew rapidly. The earlier strength of housebuilding partly reflected fundamental demand from a growing population and rapid urbanisation. This demand is now clearly slowing. China's overall population fell last year for the first time in six decades, and like the working-age population will probably shrink through the 2020s. Ongoing urbanisation may provide some offset, but still not as much support as previously. The share of China's population living in urban areas roughly doubled from the late 1990s to today (figure 4). With the urbanisation rate now about 60%, that can't happen again.

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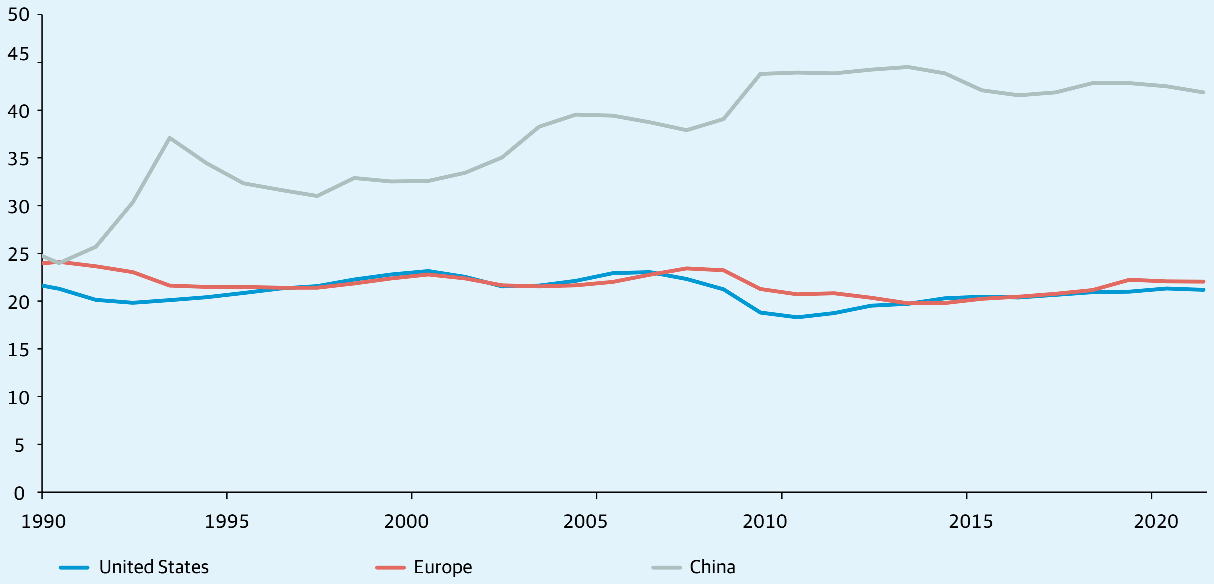
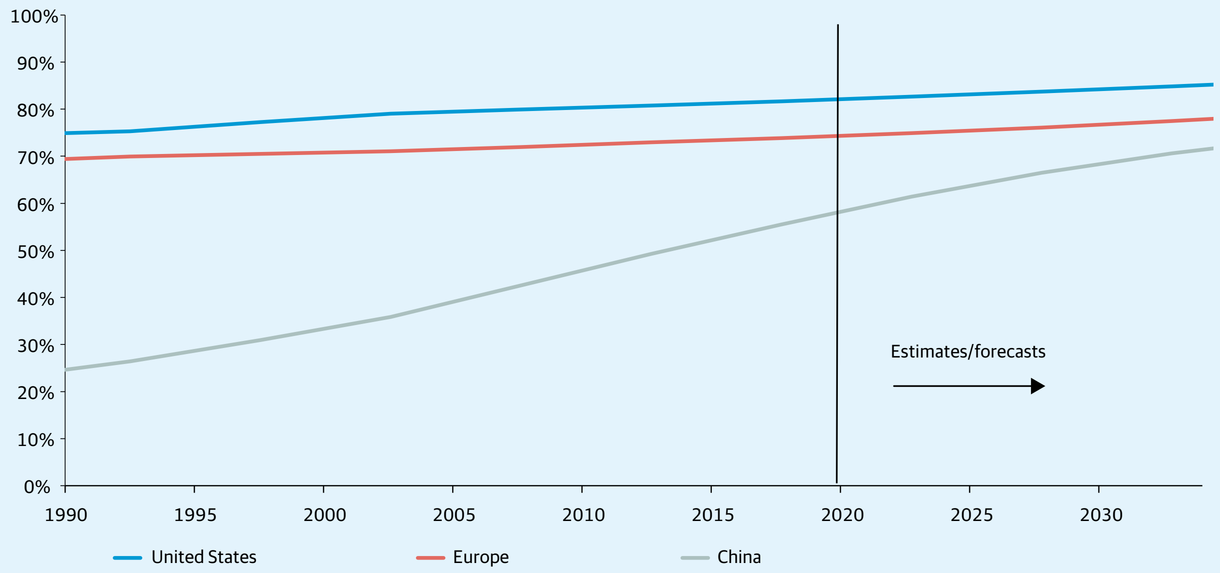
Figure 3. Gross fixed capital formation (% of GDP)



Source: Refinitiv, Rathbones

Figure 4. Urbanisation rates and UN estimates/forecasts



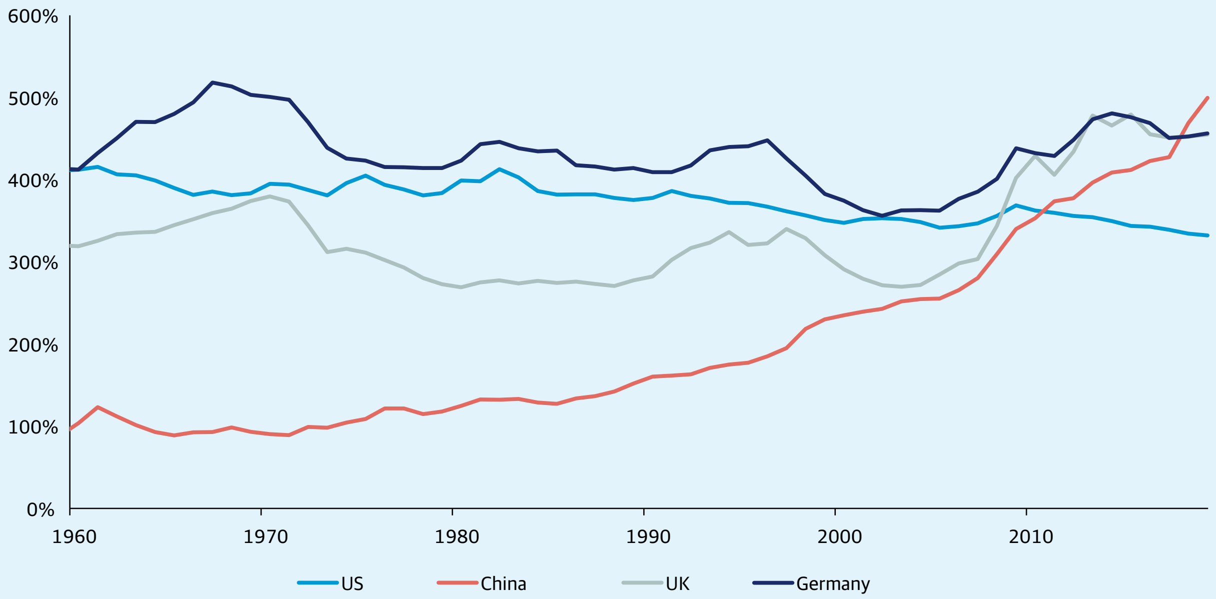
Source: Refinitiv, Rathbones

There may also be an overhang of vacant properties due to overbuilding in the 2010s, when speculation in the property market arguably led to excess construction. There's great uncertainty about the number of vacant properties, as unlike most countries China publishes no official vacancy statistics. But a report released by a Chinese thinktank last year (before being withdrawn in controversial circumstances) suggested a vacancy rate of 12% in urban areas. That tallies with pre-pandemic estimates from China's national grid based on electricity usage. These estimates probably underestimate the overall vacancy rate, since they are based on urban areas only and in most countries vacancy rates are significantly higher in rural areas. Either way, even a 12% overall vacancy rate would be high by international standards.

Admittedly, since November policymakers have introduced fresh support for the struggling property sector. But their goal seems to be to end the current downward spiral and ensure that developers are able to support the needs of the population - not to reignite the speculative boom. In policymakers' own words, the "stable and healthy development" of the real estate sector remains the priority - their slogan "housing is for living in, not for speculation" still applies.

Another key element of China's capital formation has historically been infrastructure building on a massive scale - but this is another area where growth is likely to be slower in future.

Figure 5. Capital stock as a % of GDP



Source: Refinitiv, Rathbones

The main reason is that China now has good infrastructure, and the biggest one-off projects like road and high-speed rail networks don't need to be built twice. While many other large economies have chronically underinvested in infrastructure over the past couple of decades, China has gone in the opposite direction. For example, it already has many more miles of high-speed rail than the rest of the world combined. Its capital stock is now as high relative to its GDP as in advanced economies (figure 5) - it doesn't need to keep adding to it at a much faster rate.

On a related note, there's clear evidence that China's infrastructure investment has become much less efficient over time, as it has become harder to identify projects that add a lot of value. One way of measuring this is to estimate how much investment is needed to generate an extra unit of economic growth. This figure has been rising, and by some counts is now more than double its level in the 2000s. In other words, investment is generating far less bang for its buck than it did then. This has also been a key driver of the surge since the 2000s in China's debt relative to its GDP, which has been far greater than in advanced economies. When debt-financed investment generates little extra economic activity, the result is a rising debt-to-GDP ratio.

Policymakers in recent years have implicitly acknowledged the problems with their previous reliance on infrastructure spending, and the associated surge in debt ratios. That's evident in their calls to avoid repeating "flood-like stimulus" of the past, which in practice meant vast waves of spending on traditional infrastructure. While there's still a clear need for more investment in green infrastructure, the overall scale seems likely to be far smaller.

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Productivity

More state control, more decoupling from the West

China has grown from a low-income country to an upper middle-income one since 2000. History shows that the next step, breaking out of the middle-income bracket to become a rich country on a per capita basis, is hard. Most countries with middle-income status in the 1960s and 70s are still stuck in the "middle-income trap" today (for example Brazil, Mexico, Chile, Colombia, Malaysia, Thailand and South Africa). They have failed to grow much faster than rich countries on a consistent basis, meaning they haven't caught up. And some of the handful that have broken out of the trap are small countries that followed development paths not viable for mainland China. Hong Kong and Singapore have become offshore financial hubs and entrepôts, for example, while Ireland has joined the EU and become a corporate tax haven.

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To be clear, this isn't an argument that unfettered free markets are the only path to development. China's own ascent in the 2000s shows that a country can rise from low to middle-income status without signing up to all the tenets of the "Washington consensus" on the need for developing countries to adopt market-led strategies for economic growth. And the handful of relatively large economies that have made it from middle-income to rich-country status in recent decades - namely South Korea, Taiwan, Singapore and Japan - consistently pursued active industrial policy as they scaled the global economic rankings.

However, successful state-led development of this kind has been the exception rather than the rule - witness decades of failed import-substitution industrialisation policy in Latin America. Its success in South Korea, Taiwan, Singapore and Japan depended on some key factors whose presence in China today is debatable.

First, the priority of state intervention in those successful cases was boosting export sectors and long-term growth. In contrast, the focus of China's leadership increasingly appears to be a combination of political control and self-sufficiency. To illustrate the point, textual analysis of Party Congress reports by Capital Economics reveals progressively fewer mentions of phrases for the economy, markets and reform - and more of security, the party, politics and self-sufficiency through President Xi's tenure.

There was some talk about a more liberal approach late last year following the political advancement of Li Qiang. Li is now the second-ranked official (after Xi Jinping) in the politburo standing committee and will reportedly assume responsibility for the economy later this year. As governor of Wenzhou, Zhejiang and later Shanghai, Li developed a track record of successful deregulation, support for private enterprise and attracting foreign investment. Some commentators have linked his advancement with signs that the prior regulatory campaign against China's big tech firms may be ending.

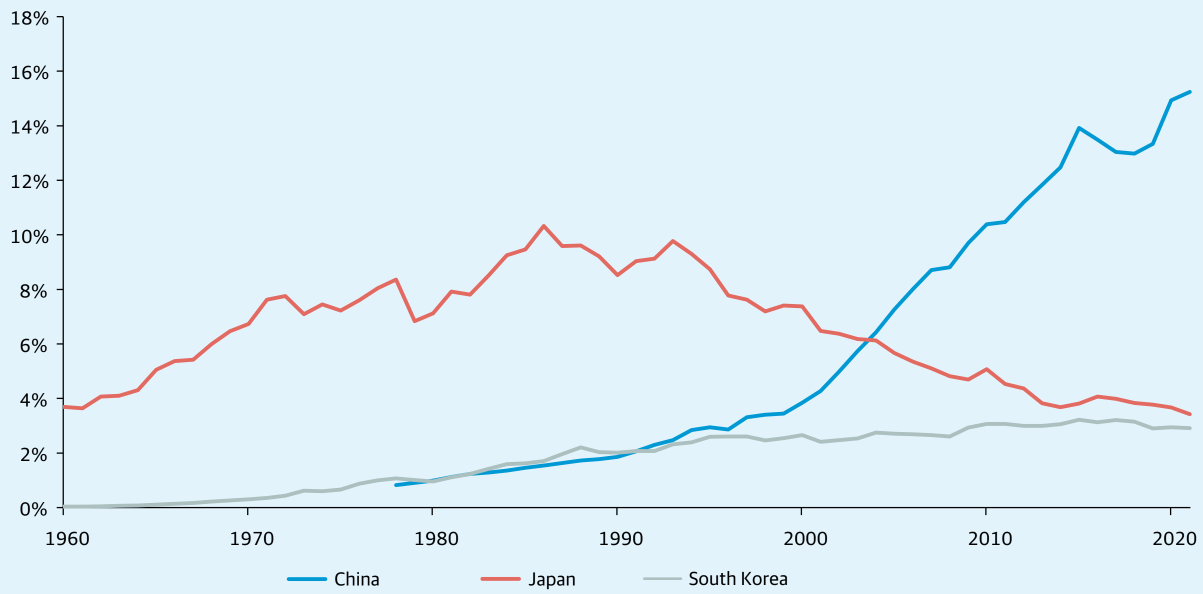
Yet we're wary of overinterpreting these developments. We know little about either the personal views of senior Chinese politicians, or their individual influence on policy. And it may simply be that the regulatory campaign against big tech firms is winding down because its main goals have been achieved. The government has consolidated its grip, negotiating bespoke deals with the largest players which give it more control. The cyberspace regulator has acquired so-called "special management shares" in Weibo, BytedDance and a key Alibaba subsidiary. We don't know exactly what powers are attached to these "golden shares", but in the past they have come with direct control over appointments to company boards and a say in management. The regulator reportedly remains in negotiations with Tencent over a similar agreement.

Second, South Korea, Taiwan and Japan all faced a comparatively friendly trading and geopolitical environment as they grew from middle-income to rich countries. They were able to increase their share of global trade, and to bring in foreign expertise and best practice to support their industries. While China was also able to do the same in the 2000s and much of the 2010s, it is now increasingly constrained on both counts.

China past its peak

China already accounts for a much larger share of global trade than Japan did at its peak, and its share had stopped rising before the pandemic-induced surge in goods demand (see figure 6). It is now facing greater resistance from overseas than Japan eventually did in the 1980s, and at a much earlier stage in its economic development. In the US, President Biden has both maintained the tariffs imposed on China under President Trump and gone much further than his predecessor in other areas. More than 100 Chinese firms linked to its military and tech sectors have been added to the US "Entity List" under Biden, which in effect bars US firms from selling to them. Meanwhile, the US targeted China's advanced semiconductor sector with sweeping restrictions last year. US firms may no longer supply advanced chips or chip-making equipment to China, and key European producers have agreed to cooperate with the US. President Biden's team is reportedly considering further measures targeting a swathe of cutting-edge sectors of China's economy, including AI and quantum computing.

Figure 6. Export share of global trade



Source: Refinitiv, Rathbones

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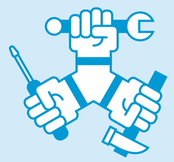
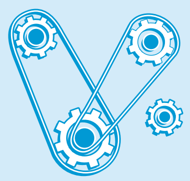
Obstacles to long-term growth in China

A summary of the economic headwinds to long-term growth in China

Long-term growth driver	Factor	Outlook
Labour 	Demographics	China's working-age population has peaked and is likely to contract over the next decade, in contrast to the US. Later this decade, China's working-age population will probably be contracting faster than Europe's.
	Labour-force participation	Scope to offset a falling working-age population with rising labour-force participation (as Japan has done to some extent since the 1990s) is limited. Working-age female labour-force participation is roughly the same as in the US and Europe, and far higher than it was in 1990s Japan.
Capital 	Residential investment	Housing construction was previously an important source of growth. But demand for new housing is falling due to a falling population and slowing urbanisation. There may also be an overhang of vacant housing following the previous property boom. Policy is focused on ensuring the housing needs of the population are met without reigniting speculation and overbuilding.
	Infrastructure investment	China's investment-led growth model has already seen it build lots of infrastructure relative to its level of development. Fewer obvious opportunities for worthwhile projects remain – China only needs one high-speed rail network, for example – and there's evidence that new projects have become far less productive over time. Policymakers are clearly concerned about the link between unproductive infrastructure investment and the surge in China's debt relative to its GDP.
Productivity 	Role of the state	Suggestions that the government's regulatory scrutiny of the tech sector is ending doesn't mean that it's relinquishing its grip. Regulators have obtained "special management shares" in key firms. And more generally, the broader political trend is towards greater state control in the economy.
	Global trade and investment environment	The few large economies that have escaped the 'middle-income trap' and joined the ranks of rich countries in recent decades have done so by a) growing their share of global trade and b) importing cutting-edge technology from overseas. But China faces an increasingly hostile geopolitical environment which constrains it on both fronts. For example, President Biden has expanded the scope of his predecessor's trade war, including imposing tough restrictions on China's semiconductor sector with support from Europe and Japan. Further restrictions are expected on US investment in other hi-tech sectors in China, including quantum computing and AI.

Source: Rathbones

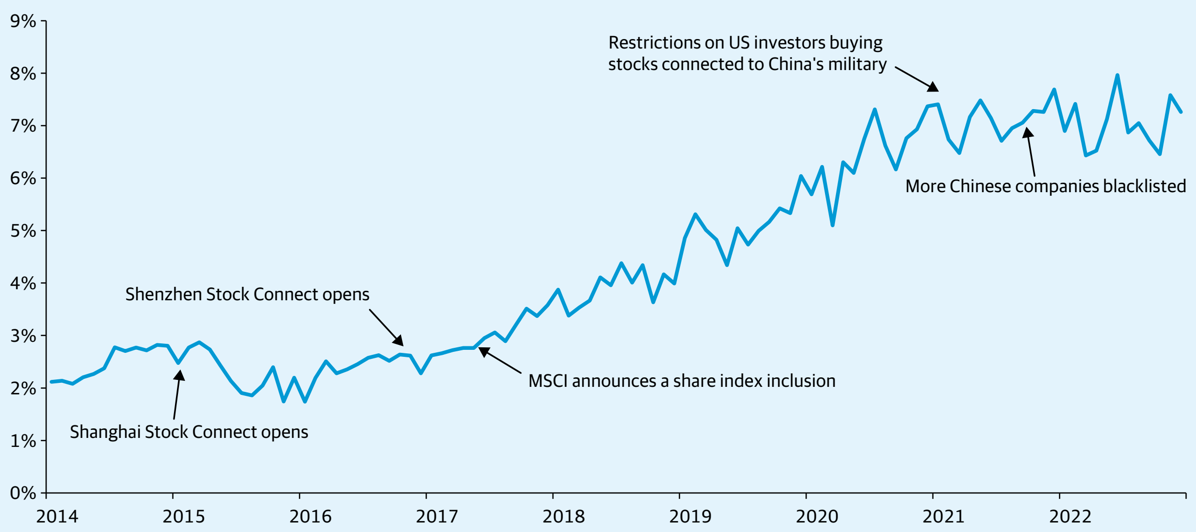
Geopolitics overshadow economics

Finally, regardless of China's long-run economic prospects, growing legal and practical hurdles may make buying Chinese equities increasingly unappealing for foreign investors.

China's integration with global capital markets steadily deepened in the 2010s (via the opening of the two Stock Connect schemes, progressive relaxation of restrictions on foreign equity flows, and decisions by index providers like FTSE Russell and MSCI to incorporate mainland-listed Chinese equities into their benchmarks). But that's changed in the past three years or so. The foreign ownership share of China's equities has already plateaued against a backdrop of US policy turning increasingly hostile to investment in China (see figure 7).

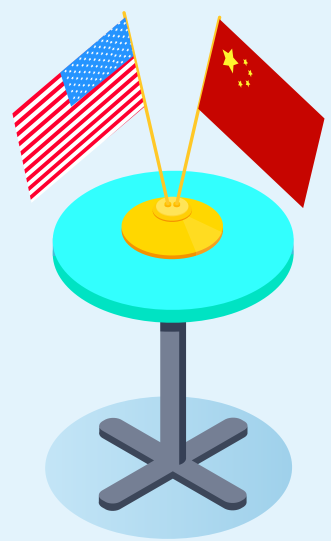
Since 2020, for example, the US has maintained a list of "Chinese military-industrial complex" firms, which are off limits to US investors (separate to the "entity list" mentioned above). Meanwhile, several major Chinese companies voluntarily delisted from US exchanges after the passage of the US Holding Foreign Companies Accountable Act, which would have forced them to disclose much more information about their operations (though many others have chosen to share the information instead). And the newly established House Select Committee on Strategic Competition between the United States and the Chinese Communist Party will reportedly consider broad curbs on US investment in China. One proposal mooted in the past has been to stop US public pension funds investing in China.

Figure 7. Share of mainland Chinese equities owned by foreign investors



Source: Refinitiv, Rathbones

Talk of a reset in US-China relations late last year amounted to nothing, with China's President Xi Jinping now railing against US "containment, encirclement and suppression" of China. Taking a tough stance on China is one of the few issues that unites Democrats and Republicans in Washington. And China's long-term aim of unification with Taiwan is an obvious potential flashpoint.



The risks seem skewed towards more restrictions like these in the years to come, perhaps causing foreign ownership of Chinese equities to fall outright eventually. Talk of a reset in US-China relations late last year amounted to nothing, with China's President Xi Jinping now railing against US "containment, encirclement and suppression" of China. Taking a tough stance on China is one of the few issues that unites Democrats and Republicans in Washington. And China's long-term aim of unification with Taiwan is an obvious potential flashpoint. The US is legally pledged to defend the island, while China has significantly increased military exercises around it in the past couple of years.

Slowing down

Yes, China is likely to get a short-term boost to growth from its 'great reopening'. But with the persistent headwinds still blowing against the three pillars of economic growth - labour, capital and productivity - coupled with these gusts from rising geopolitical tensions, it looks like investors can expect a lower speed limit on growth in China over the long term.

Important information

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