Letter n°96

What can we expect from the Chinese stock market?

"What shall we do now? Estragon says in Beckett's Waiting for Godot.

- ***Should you invest in China?*** Since the peak in February 2021, the market capitalization has dropped by 45%, or $7 trillion, while during the same period, the S&P 500 has appreciated by 31%. In Hong Kong, the Hang Seng Index in January almost fell back to its 1997 level when Alibaba and Tencent did not exist.

- ***Very low valuations***: The average market P/E ratio is low at 8x compared to the S&P 500's 20x, the price/book ratio is at 0.9x. Alibaba and Tencent, cash-rich, trade at P/E ratios of 13x when Amazon is at 40x, Alphabet at 27x, Meta at 24x.

- ***Ineffective stimulus measures***: In order to facilitate a market recovery, Chinese authorities have discussed and sometimes implemented various measures such as setting up a fund to support the market or banning short selling. However, these measures have been ineffective.

- ***Persistent obstacles***: In this Letter 96, we will analyse various obstacles - political, geopolitical, real estate, financial, demographic, economic, and international - to a recovery of the stock market.

The political and ideological constraint:

Xi Jinping, armed with the lessons of the collapse of the Soviet Union, protects himself with a powerful repressive apparatus against any democratic temptation and prioritizes domestic security over innovation and growth.

As noted by Donnet in "China, the Empire of Illusions," during the 20th Congress in November 2022, Xi Jinping mentioned the word "security" 73 times compared to 55 times in the previous congress, five years earlier, and only 16 times the word "economy" compared to 70 times five years earlier. This indicates that national security has become an obsession.

In his fight against corruption, Xi spares, as he puts it, "neither tigers nor flies," and has thus side-lined his real or potential rivals, developed a personality cult unseen since Mao, as Xi Jinping Thought is studied in universities and even primary schools.

Nowadays, there are Communist Party cells in private enterprises, including foreign companies, reducing autonomy.

Internationally, recurrent tensions are observed in the strategic South China Sea, a passage for 40% of global trade. Faced with the Chinese takeover of 4 million km2 in the South China Sea, including the entire Paracel Islands and a large part of the Spratly Islands, a takeover invalidated by the Hague Court in 2016, neighbouring countries such as Vietnam, the Philippines, and Malaysia are reacting. The Philippines, for instance, granted 4 new military bases to the Americans in 2023, three of which are close to Taiwan, and they are increasing joint patrols with the Vietnamese.

The real estate constraint:

Real estate has long contributed to 25-30% of the GDP, provided 20% of jobs, and represented 75% of household wealth, levels much higher compared to other countries. In order to increase their revenues, provinces and municipalities have multiplied land sales to developers, leading to overcapacity accumulation.

The crisis appears more severe than in Japan in 1990 because, despite the demolition of vacant buildings, the percentage of empty apartments in cities is said to be 20% compared to 10% in Japan at the time, and housing prices would be at 20 times the average income compared to 10 times in Japan.

To encourage the financial sector to assist real estate players, the limit on banks' required reserves has been lowered, but according to Gavekal, the value of unfinished housing would approach $1 trillion!

In light of this crisis, the recent decision to liquidate Evergrande, without providing assistance to the private real estate sector, corresponds to a Lehman Brothers moment for China.

The financial constraint:

In recent years, the worsening of indebtedness is evident as ratios exceed 3.5 times the GDP, with 2.2 times for businesses and households.

In this context, even though the currency is not convertible, lowering rates to stimulate growth could provoke capital outflows.

The continuation of deflation in January for a fifth consecutive month, -0.8%, exacerbates the debt problem.

The demographic constraint:

The decline: The number of children per woman has dropped to 1.05 compared to over 7 in the 1960s. The population is decreasing, by 2 million in 2022, officially lower than that of India, and, notably, is aging more rapidly than in Western countries.

The average age was 20 years in 1978, it is 40 years in 2024, and by 2040, 400 million Chinese, more than the entire population of the United States, will be over 60 years old.

The working-age population is expected to decrease by 220 million by 2050, which will require the country to increase productivity.

Given the decline in the number of marriages from 13.5 million in 2013 to 7.6 million in 2021, there is little hope for an increase in fertility, which fell to 9 million in 2023, less than half of what it was in 2016.

However, the unemployment rate is still high: According to the Chinese National Bureau of Statistics, there are reportedly 32 million active individuals among the 96 million young urbanites aged 16-24. Of these, 25.7 million are employed and 6.3 million are unemployed, resulting in an unemployment rate close to a quarter. However, among the remaining 64 million, there are 16 million young people not in school who live with their parents. Thus, the youth unemployment rate would not be a quarter but 45%.

Youth unemployment also exists in other countries like India, but in a communist economy, everyone is supposed to be able to obtain employment.

Youth unemployment is even more of a problem as many must support their retired parents, and by the age of 35, unemployed individuals encounter difficulties in finding a job.

The economic constraint:

Everyone remembers China's remarkable take-off between 1978 and 2023, as China's GDP increased more than 40-fold. However, in recent years, the country has not been able to achieve 10% growth.

According to the Rhodium research firm, growth in 2023 might not have been 5.2% but 1.5%, and according to Oxford Economics, the GDP might be overestimated by 20%. In January, manufacturing activity contracted for the fourth consecutive month.

While investments, still at 42% of GDP, have been unparalleled in the world, the country is saturated with overcapacity in infrastructure, as well as in real estate, and it will take years to reduce stocks and clean up companies in these sectors.

Efforts to ensure energy transition are undeniable, but 67% of electricity production is coal-based, with only 5% nuclear and 28% from other renewable energies.

The main idea of this Letter is that after the real estate crisis, an industrial crisis is looming. While China accounts for 40% of global industrial production, it depends on export growth. Although China identified future sectors such as solar, electric cars, and batteries in its China 2025 plan launched in 2015, it heavily subsidized them, provoking Western ire. According to an American think tank, electric cars received $125 billion in subsidies between 2009 and 2021, and overall subsidies in the industry represent between 2 and 5% of GDP annually, compared to an average of 1% in major countries.

At a time when American and European customers have decided to protect themselves from unfair competition, Chinese companies do not know how to dispose of their excesses in many sectors. Companies like BYD, number 1 in electric car production, are trying to compensate for difficulties accessing Western markets by increasing sales to countries like Indonesia or Brazil, but this will not be enough.

China must therefore revise its growth model, promote domestic consumption, which currently accounts for only 37% of GDP compared to over 70% in the United States. Among the obstacles are youth unemployment, the weakness of the welfare state, unable to absorb education and health costs or provide decent pensions ($7,000/year for urban areas and 20 times less in rural areas), and the precariousness of the Hukou system, which includes some 300 million migrants from rural areas to cities, living without social assistance.

The international constraint:

The brake on global growth: Over the past 10 years, China has generated 40% of global growth, nearly double the US contribution and four times the European contribution. In other words, out of the average 2.6% annual global economic growth over the past decade, 1.1% comes from China, 0.6% from the United States. Thus, there is concern about a slowdown in global growth.

Tensions with the world: Even though exports are slowing down, by -4.6% in 2023, the trade surplus is still $80 to $90 billion per month, causing friction.

In electric cars, there are significant overcapacities with a capacity utilization rate of 70%, leading to price wars. In Europe, the Chinese electric vehicle market share has risen from 1% in 2019 to 8% in 2022, but faced with the risk that it could reach 15% by 2025, the European Commission is considering protective measures. Overall, in the automotive industry, China became the world's largest exporter in 2003 with 5.2 million vehicles, surpassing Japan with 4 million, whereas five years ago, China exported four times less than Japan.

The decline in foreign investment in China is another cause of the slowdown in economic growth. China, a few years ago, received 10% of the world's Foreign Direct Investments (FDI), and the stock was $3.5 trillion. However, recently, the net flow (-$12 billion in the third quarter of 2023) has been negative, while investors are favouring Vietnam, India, Bangladesh, and Mexico.

Half of the American companies operating in China report being at a loss or breaking even, and a quarter have started or are planning to relocate out of China. On the European side, Ursula Van der Leyen speaks not of decoupling but of "de-risking," meaning the desire not to depend on imports from China.

Westerners no longer trust, and they have moved away from the idea that Chinese enrichment would necessarily lead to democratic evolution. They have seen Hong Kong, once fully integrated into the Western world, abruptly fall under Chinese control, and in light of the treatment of Uighurs, some, like H&M, have closed their factories.

As a consequence of the partial or total departure of companies like Mazda, Stellantis, Nintendo, Dell, Microsoft, HP, Apple, etc., China will become less and less the world's factory, and the difficulty in creating jobs will only be exacerbated.

Capital outflows: The government is combating private capital outflows to foreign destinations, particularly to Singapore or Dubai.

The decrease in trade with the United States: American barriers are high because, in addition to the tariffs imposed by Donald Trump, Biden has implemented the IRA, a $385 billion program, in the form of aid, capable of generating $3 trillion in investments.

For the first time in 2023, China is no longer the top supplier to the United States. It delivered $472 billion worth of goods, but Mexico exported $475 billion to the United States. The US trade deficit with China has decreased significantly. From $382 billion in 2022, it fell to $280 billion in 2023, its lowest level since 2010. However, the deficit with Mexico worsens. From $95 billion in 2022, it rose to $150 billion in 2023.

However, upon closer analysis, it becomes apparent that many Chinese producers have established themselves in Mexico to circumvent US sanctions. The same trend is observed with Vietnam, where the US deficit doubled in a few years to reach $104 billion.

Overall, and this is a crucial point, the Chinese content of products consumed in the United States has not decreased.

The Silk Roads are running out of steam**:** China carries out half of its trade with the 150 countries of the Silk Roads, but investments and loans have slowed significantly. Out of the $960 billion in loans made since 2013, China has already had to restructure $250 billion.

The African example illustrates this evolution. Between 2000 and 2022, China, eager to monopolize African mineral reserves, lent $170 billion to Africa. However, between 2021 and 2022, there were less than $2 billion in loans because China has indebted these countries so much that many, like Ethiopia, Ghana, and Chad, can no longer repay.

Exporting deflation: The decline in the PPI, producer price index, signifies an export of deflation. This occurs when companies like BYD decrease the prices of their electric vehicles sold in Germany by 5 to 15%.

Conclusion:

- ***A structural slowdown in growth***: China may never become the world's superpower. Per capita GDP, at $13,000, remains (and will likely remain) low, far from the $70,000 recorded in the United States. While nominal growth approaches 5% in 2024, after accounting for deflation, it will not exceed 4%, and the IMF anticipates only 3.5% growth per year in the coming years.

  Among the causes of the slowdown analysed in this Letter 96, the primacy given to ideology and state-owned enterprises, the weight of arbitrariness undermining investor confidence, hyper-centralization, the inability to continue overinvestment in currently overcapacity infrastructure, and above all, the inability to transition from an industrial model to a consumption and services-based economy, are all significant constraints.

- ***Disappointments***: The regime has always kept the population out of politics but has offered rapid enrichment as a counterbalance in recent decades. Today, enrichment is slowing down, and there is even a loss of savings in real estate. Faced with persistently high youth unemployment, the dictatorship will not collapse, but the Chinese dream of winning over the masses is fading, and the loss of confidence is undeniable.

- ***The rise of international grievances***: Since the implementation of the aggressive "Wolf Warrior" diplomacy, the proportion of unfavourable opinions about China has continued to increase. In all Western countries, it stands between 75 and 85%, double what it was twenty years ago. While less true in emerging countries, the percentage is also deteriorating.

- ***Persistent caution in the stock market***: The Chinese stock market is undervalued, but it will not attract international investors through market support budgets or favourable free trade speeches. The prerequisite to reconcile investors is an ideological shift, and one can conclude with ***François Villon's words in the Ballad of Contradictions: "Nothing is sure for me but what's uncertain."***

Geneva, 14 February 2024

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