SingAlliance

Letter n°112

What do we make of China's stimulus measures?

"Hide your splendour, feed the darkness" Deng Xiaoping.

If that was Deng Xiaoping's motto, today, with the announcement of these measures, we could reverse the words to say, "Hide the darkness, feed the splendour."

The resurgence of the Chinese stock market is due to a flurry of announcements and a series of stimulus measures: monetary, with rate cuts; fiscal, to encourage consumption and investment; and even stock market-related, with funds dedicated to supporting stock prices.

These measures have led to a stock market surge, but economic indicators remain disappointing.

- ***The stock market surge***:

According to Morningstar, during the first 8 months of the year, international investors had reduced their exposure to Chinese stocks listed in New York and Hong Kong by $4.2 billion. At the same time, foreign investors had largely abandoned the Chinese market, accounting for only 10 to 15% of daily trading volume.

After several years of unmet expectations and repeated declines, the Chinese CSI index of the 300 largest companies has appreciated by 26% since the first announcement of economic support. This increase is enough to erase the losses of the last 14 months. Since the beginning of the year, we can observe the outperformance of the Hong Kong stock market compared to that of New York.

Whether this rise is sustainable or short-lived is the question on the minds of investors, some of whom are worried about losing their capital in this authoritarian country, while others have been burned by numerous false starts in recent years.

One recalls the 150% appreciation of the Shanghai stock market between June 2014 and June 2015, followed by the erasure of most of these gains within two months.

- ***Disappointing economic indicators:***

Is China's struggling economy, which is aiming for 5% growth this year, going to recover?

From a cyclical perspective, the indicators point to disappointments: a fifth consecutive month of contraction in manufacturing output, and retail sales increased by only 2.1% in August year-on-year.

To date, the total measures proposed represent the equivalent of 3% of GDP, a percentage much lower than the stimulus effort in 2008, which exceeded 10% of GDP. Following these announcements, the World Bank did not find it necessary to change its growth forecasts, predicting 4.8% growth this year and 4.3% next year.

Will these measures truly boost growth, or will they simply allow the 5% target to be met this year? Will it be possible to put an end to deflation? What should be made of the issuance of $285 billion in bonds, primarily intended to refinance debt? How will this stimulate consumption? Once again, the measures prioritise supply over demand. What should be thought of a recapitalisation of public banks to encourage them to take more risks in a context of depressed margins? Caution remains, as the economic indicators have been disappointing, the amounts proposed are insufficient, and structural obstacles abound.

The thesis developed in this Letter 112 is simple: investors, seeking confidence after years of setbacks, cannot be satisfied with cyclical measures and are waiting for "pro-business" structural reforms that favour private companies. And for now, there are no signs of this. To support this thesis, we will successively analyse the measures and the obstacles.

The measures:

Xi aims to reduce the reliance on real estate for growth, ensure an exit from the real estate crisis, and further promote technology as a new driver for creating skilled jobs, reducing unemployment, raising incomes, and therefore boosting consumption. However, there are few concrete measures to increase the weight of consumption, which remains low at less than 40% of GDP.

Monetary measures:

A reduction in banks' required reserves and a 0.50% decrease in mortgage rates for real estate borrowers.

Fiscal measures:

In 2009-2010 and 2015-2016, the stimulus plans represented a massive effort, equivalent to 15-20% of GDP. For now, the announced measures do not exceed $285 billion, or 1.5% of GDP.

The weaker effort is due to the fact that the public sector is now indebted, and the legacy of previous plans showed significant inefficiency in allocation and the creation of overcapacity through those investments. It's clear that the goal today no longer seems to be achieving 8-10% GDP growth, but simply reaching the 5% target announced at the beginning of the year.

The government is considering a $285 billion bond issuance to finance transfers to households. These bonds would be purchased by Chinese institutional investors, who are wealthy from household savings deposits. In other words, this may provide a way to recycle the excess savings.

Unlike previous stimulus plans, the announced measures do not aim to invest in manufacturing, as many sectors are already affected by overcapacity. The goal is to support consumption, potentially through "vouchers," though there are few concrete measures.

In the very short term, around €15 billion has been announced to support investments in sectors deemed strategic. This remains modest, and the market is hoping for a recapitalisation of major banks to strengthen credit and boost growth. The government is preparing to increase the capital of the six major public banks by 1 trillion yuan, nearly €130 billion, but this will not be enough.

Real estate measures:

For years, real estate developments and the appreciation of housing prices were a key driver of wealth for Chinese households. The majority of their wealth, 60% of their savings, was directed toward real estate, as they lacked the ability to invest abroad.

This led to overcapacity, and a real estate crash began just over two years ago. According to Barclays, Chinese household wealth has dropped by $18 trillion, which translates to $60,000 per family. Huge amounts.

In May of this year, the Central Bank had already provided local banks with over $40 billion to enable them to lend to state-owned companies that could acquire empty homes, but the impact remained limited.

Recently, the government authorised local authorities to purchase more land, lowered the required equity for the acquisition of a second home from 25% to 15%, and reduced interest rates by 0.30% to 0.50% to facilitate the refinancing of loans.

Following the announcement of these recent measures, during "Golden Week," new home sales increased by more than 20%, and in Beijing, even by 80%.

Stock market measures:

The People's Bank of China has allocated $115 billion to assist companies in financing stock buybacks and to encourage institutional investors to invest in the Chinese stock market. The first tranche of €65 billion from this program was officially launched on 10 October.

The idea is to increase the influence of institutional investors in the market. In 2019, they held 17% of the free float, and this year that figure has risen to 22%.

The risk for investors is borrowing to buy stocks and potentially facing losses if the stock prices fall afterward.

More long-term, the idea of a market support fund has been discussed, but we remain sceptical of this measure, as it was previously introduced by the Bank of Japan with limited success.

The 5 obstacles to accelerating growth:

1st obstacle, ideological hardening, a barrier to stock market development:

The poor handling of COVID, the crackdown on entrepreneurs (e.g., Jack Ma and other prominent figures accused of corruption), political tensions in the South China Sea and internationally, and support for Putin all reflect this ideological hardening. There are three key consequences:

- Weak IPO activity:

Political control hinders stock market growth. In the first nine months of the year, IPOs raised less than $7 billion, not even a fifth of what companies raised in the U.S. in the same period. In 2020, Alibaba and Tencent's market capitalisations reached $1.5 trillion, but following the crackdown on wealthy individuals, their combined value has plummeted to $775 billion.

- Weakening of venture capital:

Political control also restricts the venture capital sector. In 2021, the sector raised $42 billion; in the first nine months of 2024, it raised just $6.4 billion, 40% less than the same period in 2023, according to Dealogic. The number of start-ups dropped from 51,000 in 2018 to just 1,200 in 2023. Funding for biotech and pharma fell by 60% between 2021 and 2023.

Today, 80% of venture capital funding comes from the state, either through public banks or government agencies. In April, the People's Bank of China set up a $70 billion facility to encourage lending to tech firms, prioritising semiconductors, AI, and biotech.

- Decline in foreign investment in China:

Foreign direct investment, which averaged $14 billion annually between 2018 and 2022, is now virtually non-existent.

Taiwan's investments in China are a telling example: in 2010, 83% of Taiwan's foreign investments were in China, but by 2023, this had dropped to just 11%, due to rising production costs, political tensions, and a desire to diversify investments, particularly toward Southeast Asia.

2nd obstacle, public debt, a barrier to stimulus measures:

Central government debt is low, but when combined with the provinces and local authorities, which account for 80% of GDP, it exceeds 1x GDP.

China is also heavily committed to many emerging countries involved in the Belt and Road Initiative. Many of these nations were pushed to borrow beyond their repayment capacity and are now struggling. The People's Bank of China reportedly holds over $580 billion in emergency loans, provided through Yuan swaps at high interest rates, to help these borrowers repay Chinese banks.

3rd obstacle, weak domestic market exacerbated by demographic aging:

Service sector activity contracted in September. Consumer confidence and spending are weak, even though measures have been taken to support employment for young graduates. Youth unemployment remains high, social mobility seems blocked, and the 300 million Hukou (rural migrants to cities) suffer from a lack of legal status. Rural residents are underrepresented in universities, and the 80 million Party members remain an isolated elite. Inequality is significant, and there is little welfare state to cushion or compensate for these inequalities. Furthermore, 70% of household savings, funnelled into real estate, has been severely impacted by the ongoing property crisis. During the recent Golden Week, there was an increase in local tourism, which is cheaper than traveling abroad, with most international travel being to nearby Asian countries.

The proposed raising of the retirement age to 63, or even 66 for men, has been poorly received. Some view it as a barrier to reducing the significant youth unemployment rate (which exceeds 21%), while others fear it will reduce the time available to care for grandchildren in a country with limited childcare facilities. Many of the 300 million Hukou workers feel unaffected by this policy, as they do not have pension systems and are entitled to less than $30 per month.

4th obstacle, industrial overcapacity and growing export pressures:

Recently, the export orders index indicated a decline, a bad omen for a country that relies heavily on export growth.

- Record manufacturing trade surplus:

The manufacturing trade surplus represents 2% of global GDP, a figure never seen with Japan or Germany. The only industrial surpluses in 2023 reached $1.75 trillion, a significant increase since 2019, covering all sectors from textiles to steel production.

In the steel sector, local production stands at 1 billion tons, but only 1% of steel mills are currently profitable. Exports, at cutthroat prices, amount to 90 million tons in 2023, a 35% year-on-year increase. While this may seem like a small percentage of total production, it is equivalent to the combined production of the United States and Japan. As a consequence of these exports, Arcelor Mittal saw its profits drop by 70% in the second quarter. The primary destinations for these exports are emerging countries, where demand is growing rapidly; however, many, like Tata in India, are complaining of unfair competition.

In the automotive sector, the Chinese Automobile Dealers Association announced $20 billion in losses due to unsold inventory.

- Increasing barriers against China:

In 2024, the United States raised tariffs on Chinese electric vehicles, steel, and aluminium. In Europe, transitional tariffs, which can be as high as 45% on Chinese cars, have become permanent for the next five years.

Outside the OECD countries, Mexico's new president aims to reduce dependence on China, which currently accounts for 20% of Mexican imports. Protectionist measures against Chinese steel have also been implemented by countries like Turkey, Brazil, Thailand, India…

- China circumvents barriers:

One example among many is Vietnam. Between 2018 and 2022, U.S. imports from Vietnam tripled to $135 billion, while Chinese exports to Vietnam increased by 75% to $147 billion, and Chinese foreign direct investment in Vietnam doubled.

In response to protectionist measures, China is also erecting its own barriers, with the latest example being French cognac, which faces a tax increase of 30% to 39%.

5th obstacle, the persistence of the real estate crisis:

For years, real estate activity, broadly defined, accounted for a quarter of GDP. Many cities, eager to generate additional revenue, sold land. However, in 2020, concerned about the situation, Xi halted this expansion and stopped providing support to developers, leading many, including Evergrande, to file for bankruptcy.

The government wants to turn the page on the real estate crisis; property values have rebounded on the stock market, but the announced measures have not convinced observers, as they do not address the problem of unsold inventory or, worse, prepaid but unfinished projects.

The absorption of these 60 to 90 million unsold homes is hindered by a declining population: an estimated decrease of 200 million over the next 30 years.

New home prices in major cities dropped by nearly 6% year-on-year in August, while existing home prices fell by more than 8%. A downward spiral could set in if investors ultimately capitulate under continuous price declines.

What is the outlook? While major economic metropolises should be able to absorb this inventory, it will be much more challenging in smaller cities, where the unsold homes can represent up to a quarter of total housing and many of these cities are emptying in favour of larger ones.

One-third of these unsold homes may never have been sold, while two-thirds were sold, often as investments by savers but remain unoccupied, hence generating no income and negatively affecting household confidence and spending ability. It is therefore difficult to consider demolishing homes to reduce inventory.

In addition to these millions of finished but unoccupied homes, there are about 20 million unfinished homes, as developers have gone bankrupt in the meantime.

Some estimate the cost of repurposing vacant homes into public housing in just the 50 largest cities to exceed $400 billion.

In the meantime, municipalities have lost valuable revenue due to the drop in land sales and struggle to maintain public services or even pay their employees, leading to discussions about privatising certain services.

Conclusion: ***"When a man is at the bottom of the well, they throw stones at him" Chinese proverb.***

The Chinese economy is facing difficulties and is attempting to increase its exports through subsidies, while customs barriers are becoming more numerous. Here are five key points to consider:

- ***Doubts about this stock market rally***:

Chinese stock market rallies are often driven by the announcement of stimulus measures and have frequently outperformed recent gains. One might think that this rally is not over yet. A rally can create a wealth effect that could lead to increased consumption. But, even if the P/E is 10x expected earnings and even if this level corresponds to the biggest discount to the S&P500 since 2010, we remain sceptical and cautious.

- ***Limits of the stimulus***:

Do the announced measures have a temporary effect or a lasting impact? The government discusses an effort between 1 trillion and 3 trillion yuan, while the markets believe a 10 trillion yuan effort, or 8% of GDP, is necessary. Underneath these hasty announcements lies the concern that the goal of 5% growth may not be met, but there is no ideological shift toward innovation or the freeing of private initiative. There have been no announcements of structural reforms likely to put an end to deflation, boost consumption or free up private initiative.

- ***Lessons from the past:***

Overall, the measures are somewhat comparable to those of 2008; however, at that time, they left local governments heavily indebted. Less money should be directed toward infrastructure, which is already facing

overcapacity, and more should focus on supporting private entrepreneurs and consumption through wage increases.

- ***Sectors or international companies likely to benefit from a recovery in the Chinese market***:

To take advantage of the market opportunities presented by these measures, investments can be made in commodities such as copper, iron ore, and oil, as well as mining stocks like Freeport and Rio Tinto. Luxury brands like LVMH and Kering, along with automotive companies such as BMW and Mercedes, could also benefit. However, caution is warranted for luxury stocks, as sales are expected to decline by 7% this year and political pressure against ostentatious luxury is high. This political pressure also negatively impacts German automobiles.

Conversely, a sustained appreciation of the Chinese market could harm other Asian markets that have benefited from capital outflows from China in recent months.

- ***The Trump threat***:

Investors seeking confidence cannot overlook the risk of a Trump re-election and the potential implementation of a 60% tax on imports from China, measures that would certainly hinder growth prospects.

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