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The Implications of China's Far-From-Typical Recovery

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As the global economy lurched from crisis to crisis over the prior decades, China provided a significant source of growth that helped limit the depth and/or the duration of the contractions. However, China's current recovery is emerging unlike its others - a development underscored by this week's cut in key lending rates, the prospects of which we previously flagged - leaving the global economy without the familiar engine to pull it forward as recession concerns linger throughout much of the world.[1]

China's traditional method of boosting growth when needed or desired (e.g., after the global financial crisis of 2008) produced beneficial ripple effects throughout the global economy. China opened the credit spigot in order to boost public and private investment, the latter of which was particularly concentrated in real estate. The hard commodities and capital goods needed to drive these investments consequently provided a lift to commodity exporters, such as Chile, Brazil, and Australia, as well as capital goods exporters, such as those in Germany and Eastern Europe.

China's current recovery is taking an entirely different shape. The country is not only experiencing diminishing returns from its investment-driven model (more on that below), but it is also facing the end of the global lockdown-related export boom. As a result, this recovery will increasingly rely on the Chinese consumer. However, recent data show that the rebound in real retail sales activity is already stalling and still far below the pre-2020 trend - the exact opposite of the U.S. recovery (Figure 1).

FIGURE 1: The Stalling Revival in China's Retail Activity (indexed to 100 as of July 2019)

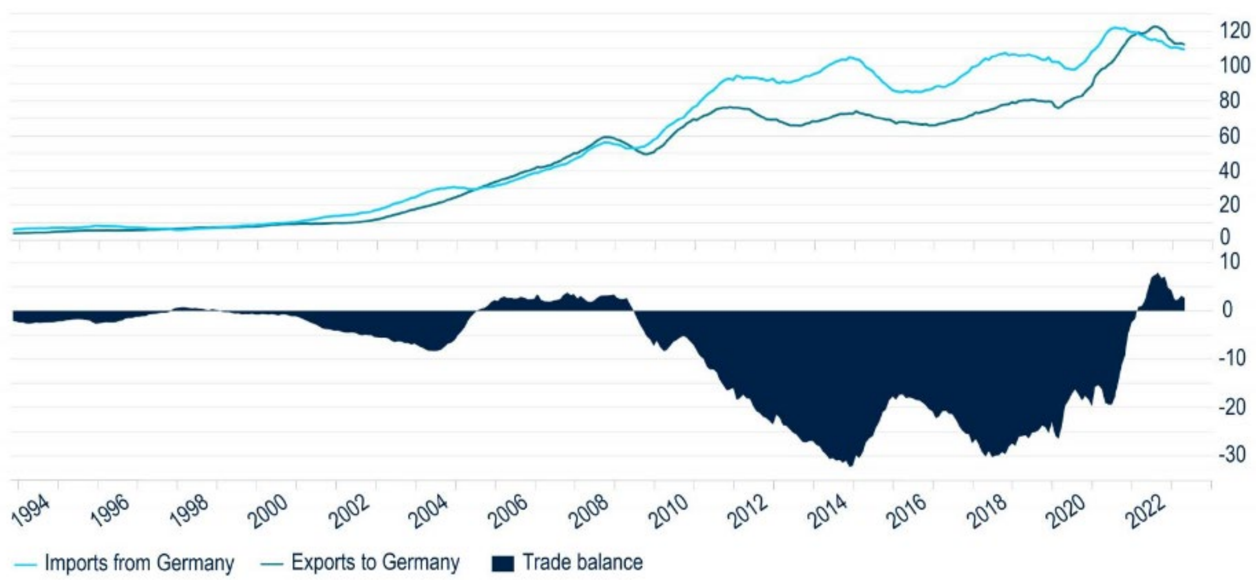
Source: PGIM Fixed Income and Macrobond.

This contrast is not surprising, given that Chinese consumers received far less stimulus support than U.S. or European households, and their limited resources underscore the altered state of China's current recovery.

The Global Effects

The muted increase in China's consumer activity has been accompanied by a moderation in its traditional investment indicators, such as demand for hard commodities including copper, iron ore, and cement, as well as its trade activity with Europe. For example, Figure 2 shows that as China's trade volume with Germany has rolled over, its trade balance with Germany has flipped to a surplus - meaning that Germany's balance has flipped to a deficit. A significant reduction in auto exports to China is playing a notable role in the trade deficit, especially amid the surge in China's electric vehicle sales domestically and abroad.

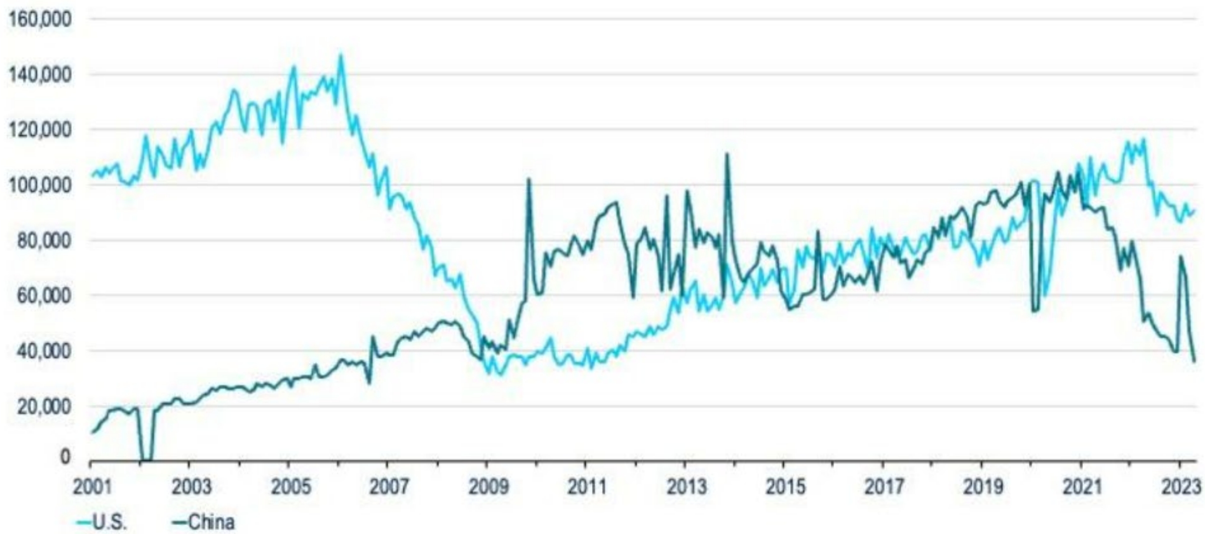
FIGURE 2: The Changed Trade Dynamic Between China and Germany (USD in billions)



Source: PGIM Fixed Income and Microband.

While China's consumers may provide some support for crude oil and food commodities, their focus on real estate investments may have also run its foreseeable course. After years of emphasis, Chinese households own the most property on an internationally comparative basis, and, consequently, the country's property market became the world's most expensive.[2] Given the sustainability questions arising from these real estate dynamics, China's authorities cracked down on over-levered property investors as part of their "three red lines" policy during the height of the pandemic. That timing likely exacerbated the massive country-wide shock to the sector, putting a huge dent in consumers' wealth perception and shattering their concept of property as a store of value. In turn, housing starts declined precipitously - a far worse performance than the U.S. housing market - representing an ongoing source of concern for investors (Figure 3).

FIGURE 3: Unlike the U.S., China's Housing Starts Remain in the Basement (in thousands)



Source: PGIM Fixed Income, Census Bureau, National Bureau of Statistics China and Haver Analytics.

Upon observing the scale of the carnage, Chinese authorities launched an initiative at the Communist Party Congress in October 2022 to revive the sector with various incentives. Yet, that only produced temporary improvements at the margins (i.e., the completion of previously started buildings), and demand already appears to be weakening with half of the year still to go.[3] China's property market is unlikely to receive meaningful support from the labor market, which has significantly worsened, particularly for the young and for university graduates. Indeed, the youth unemployment rate has risen to a historic peak of more than 20% - and that is before 10 million+ new graduates hit the labor market at the end of summer of 2023.[4]

Why Not the Tried and True?

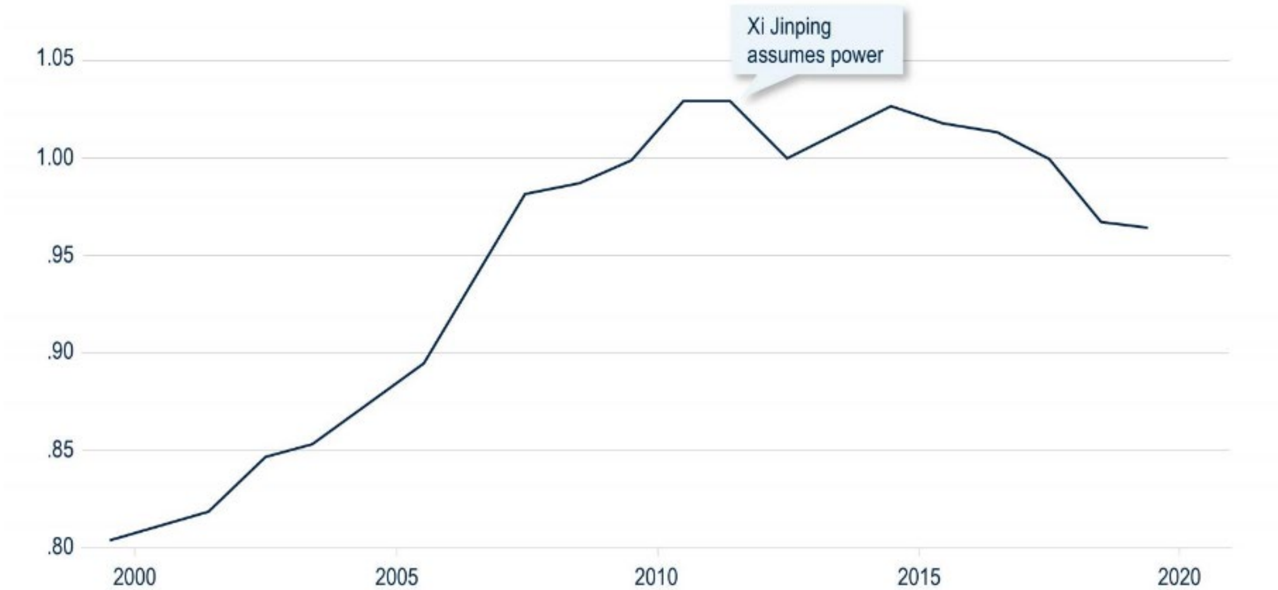
The points above raise the question of why China doesn't revert to its tried-and-true economic recovery methods. Broadly speaking, the shrinking returns and increasing risks from those methods have made the authorities reluctant to pursue them.

Starting at the macro level, by repeatedly flooding the economy with credit, China has placed itself in a cyclical debt dilemma. A debt-to-GDP ratio of roughly 300% with an average interest rate around 5% produces an annual interest expense of 15% of GDP vs. the country's nominal GDP growth rate in the recent range of 6%-8%. Therefore, from a fundamental credit perspective, China's annual interest expenses are twice the level of its organic GDP growth - it's never a great story when a borrower needs to incur additional debt just to pay its interest.

That troublesome dynamic is also at the heart of our view on China's interest-rate policy: rates will need to decline even further in order to facilitate its ongoing debt service. A reduction in interest rates consequently affects the currency exchange rate, which is already on a weakening trend, but can boost the competitiveness of Chinese exports. Moreover, given the risk of backsliding into worse-than-acceptable growth and employment outcomes, we expect the Chinese authorities to reverse course and roll out additional fiscal stimulus over the coming months. Those potential adjustments feed into our higher-than-consensus forecasts for real GDP growth of 5.7% in 2023.

However, China's medium-term growth drivers appear increasingly weak as they consist of excess manufacturing capacity and deteriorating demographics amid a rapidly aging population.[5] One way to assess these growth drivers is through total factor productivity, i.e., how effectively a country uses its resources to generate growth. It's a measure has rapidly declined in China over the past 10 years (Figure 4).

FIGURE 4: China's TFP Reveals an Increasingly Inefficient Use of Resources (ratio; indexed to 1 as of 2017)



Source: PGIM Fixed Income, Penn World Tables and Macrobond.

Given that the key fundamental drivers of China's medium-term growth are weakening, our GDP forecast for 2024 indicates a moderation to 4.5% that will likely continue. Over a five-year period, the country's growth may approach its potential at slightly less than 4%, and its growth potential may subsequently moderate to less than 3% over the coming 10 years.

Turing to the geopolitical sphere, the rising tensions between China and the U.S. certainly factor into our view as well.[6] Developments in the South China Sea provide an example of why we don't see conditions improving anytime soon. If China's leadership views the country as an emerging global power - returning to a position it held in pre-industrial times - that projection is regionally evident in its naval expansion and island building in the South China Sea, which is a major global shipping route. However, the U.S. and its regional allies continue to push back against that expansion. These unaligned views - China's belief in its right to bolster its regional presence and the U.S. intentions of maintaining post-World War II international norms - are at the basis of these escalating tensions.

In an economic context, the geopolitical strain is highlighted by the expanding technology divide between China and much of the developed world where the latter is increasingly hesitant to share advancements and data with China. Although China is a significant market, the divide exposes China's risk of becoming a data and technology island with its attendant growth implications.

When applying these considerations to investment implications, we'll summarize the points from our recent podcast. Bonds at the sovereign/quasi-sovereign level appear overly rich, and while the corporate sector provides plenty to analyze, we've been very defensively positioned across our emerging market and multi-sector portfolios. As we alluded to above, we see further weakening in the Chinese yuan, hence we're maintaining a slight underweight to the currency as well.

Concluding Thoughts

As the debate and uncertainty about the direction of the global economy continues, China will no longer provide the growth engine that will pull the broader world economy out of any doldrums. In fact, over the medium term, weakening fundamentals and an emphasis on domestic consumption could well imply a pace of growth that rapidly converges with the developed world.

That leads us to two further points where we would expect less change - in contrast to claims from much of the punditry. The first addresses the concept that near-shoring initiatives are on the cusp of draining China's manufacturing demand. Although excess capacity exists, China's economic structure has made it the world's factory, and that won't unravel quickly. For those pointing to other manufacturing bases, such as Vietnam or Mexico, that may experience an increase in manufacturing demand, they will consequently need to import more components from China in order to meet that demand.

The second point pertains to the prospect that, over time, the Chinese yuan will usurp the U.S. dollar as the world's reserve currency. But for any currency to do so, capital needs to flow freely. The steps that China will need to take in order to manage its debt load - notably lower interest rates with a resultant drag on the yuan - require capital controls, lest capital flight becomes an increasingly tangible risk. Indeed, China's capital account is tightly controlled, which is not something global investors are accustomed to, or want, when deploying capital overseas. Thus, for the foreseeable future, the yuan poses little threat to dollar primacy, particularly as China's recovery takes a shape unlike those of the past.

1. The People's Bank of China reduced the rate on seven-day repurchase operations from 2.0% to 1.9% and reduced the rates on its standing lending facility by 10 bps. We anticipate fiscal stimulus measures may follow the latest easing in monetary policy.

2. Based on homeownership percentage by country, home price-to-income ratios, and asset class valuations. These findings are referenced from "Peak China Housing," National Bureau of Economic Research, August 2020.

3. A similar "red line" scenario unfolded with China's crack down on its education and technology sectors, with the latter affecting household names, such as Alibaba, Ant, and Tencent. However, since then, it appears there's been a recognition that the crackdown stifled some of the most innovative and valuable Chinese companies, and the authorities are increasingly cognizant of the effects of standing in their way.

4. Based on Chinese government data.

5. While there are policies to support the labor force, such as increasing the retirement age, such moves jeopardize a popular backlash, which the authorities are very keen on avoiding.

6. Although we do not see an improvement on U.S./China relations over the foreseeable future, we see a relatively low probability of a conflict over Taiwan. However, we anticipate that tensions regarding Taiwan will remain elevated.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of June 13, 2023

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