JOHCM Funds

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Emerging Markets Spotlight

On China: Not a typical emerging market crisis

The market's excess optimism of the last few years seems to have ended completely. Yet China has all the building blocks of a powerful recovery when Covid lockdowns end.

It isn't our intention to write so much about China. The other 23 Emerging Markets countries also have our full attention, but news flow isn't evenly distributed across the globe.

Below, we cover three aspects of what is happening in China: Covid lockdowns, protests and monetary easing.

KEY POINTS

- China's vaccination rates make the government's desired full Covid re-opening difficult, even if the social and economic pressures to do so soon are compelling.
- The national protests in China are unusual, but small and likely to end in a crackdown as they did in Hong Kong in 2019-2020.
- Chinese monetary stimulus continues to pick up. Confidence and demand for credit are low, but the conditions for a powerful economic rebound are being put in place for when those improve.
- We remain underweight, but less so than in previous quarters, and are looking for signs of improvement.

COVID POLICIES IN CHINA

The Covid situation in China remains difficult. Covid transmission has been suppressed through restrictions on personal freedom and economic activity that have been brutal even by global Covid lockdown standards.

These are increasingly being challenged by street protests, as well as creating a serious drag on the economy. The authorities recognize these issues, and seek to finesse a controlled re-opening, as seen in a recent 20-point refinement of Covid policies.

Although China's Sinovac vaccine is marginally less effective than some of its peers, it was the main vaccine used in Chile – which has managed a full re-opening. It is not the quality of China's vaccine that is the challenge.

Vaccination and booster rates in the elderly are low and a problem – reportedly less than 50% for the over-80 and less than 70% for the over-60 populations[1]. Current Covid strains have similar morbidity as the early ones for populations lacking vaccinations and/or previous exposure. A rapid full re-opening may risk a major outbreak, which could manifest a significant death toll, particularly among China's elderly.

Chinese authorities have consistently conveyed that their Covid response has been superior to the West, because of the low death toll achieved within their states. It is therefore a major concern of policymakers that re-opening is done carefully, as a spike in deaths would undermine this message and question the last year of lockdowns.

However fast the authorities choose to re-open, the economy remains very weak, and almost all the economic data released in November has confirmed a slowdown.

PROTESTS IN CHINA

Recent evenings have seen street protests against China's strict Covid policies where national-scale protests are very unusual. Demonstrators estimated to be in their hundreds gathered in Beijing and Shanghai, as well as in smaller cities Chengdu, Xi'an, Wuhan, and Urumqi. In addition, some protesters have been openly criticizing the Chinese Communist Party and President Xi.

We think that the authorities would not allow street protests of any size. As well as the previously noted reluctance to relax COVID control policies, there will also be a refusal to be seen giving in to popular protests. It should be noted that Chinese authorities have experience addressing protests in Hong Kong as recent as 2019 and 2020.

Through control of the media and the streets, by conducting mass arrests and taking punitive legal action against those arrested, Chinese authorities easily have the capability to deal with current protests. There is the possibility of further refinements and recalibrations of Covid restrictions, designed to ease public anger and support the economy.

A final thought on protests: abrupt political change tends to come shockingly fast.

The accounts of the fall of communism in Central Europe in 1989 show that almost no-one expected it, even those who would lead the revolutions[2]. The same was true of the Arab Spring in 2011[3]. Momentum and positive feedback loops apply to politics as much as they do economics and markets.

It is possible that the current Chinese protests develop into a change of leadership or even of regime in China, but we feel that that, almost by definition, would be unpredictable. **We prefer to invest in China based on existing circumstances and the most likely outcome, which is the status quo in Beijing.**

MONETARY POLICY IN CHINA

Against this backdrop, China has steadily loosened their monetary policy, although with no immediate effect.

The most recent step was a 0.25% cut in banks' required reserve ratios[4], which will create an additional RMB 500bn in base money from the first week of December. Meanwhile, base money (M0) grew 14.3% YoY to October,

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[1] https://www.economist.com/china/2022/04/02/why-so-many-elderly-chinese-are-unvaccinated

[2] https://ir.lib.uwo.ca/economicsperg_ppe/19/

[3] https://as.nyu.edu/content/dam/nyu-as/faculty/documents/Why_We_Were_Surprised_Again.pdf

[4] https://www.bloomberg.com/news/articles/2022-11-25/china-s-central-bank-cuts-reserve-ratio-to-help-bolster-economy

suggesting an aggressive liquidity push into the financial system.

However, Chinese monetary policy is currently at the 'pushing on a string' part of an economic crisis. While corporate and household confidence is low, borrowing remains depressed, and excess liquidity is building up as bond holdings, corporate deposits, and household savings. One feature of this is that household term deposits are growing faster than household demand deposits, as households do not expect any near-term desire or opportunity to spend. Another is that aggregate household borrowing fell in the first three quarters.

This excess liquidity/depressed confidence environment can also be seen in inflation and interest rates. Core CPI in China declined to 2.1% in October, while PPI is negative. Additionally, the market-driven interbank repo rate has been consistently below the PBoC's policy repo rate, suggesting a shortfall in demand for borrowing.

For the time being, there seems to be little prospect of the monetary push turning into end demand in the real economy. Investors should note, however, that aggressive monetary interventions do tend to work in the end.

With large amounts of monetary liquidity building up in the Chinese financial system, repressed demand, no inflation and a current account surplus, China has all the building blocks of a powerful recovery whenever the Covid lockdowns end. Whilst no catalyst can be seen, this is not a typical emerging market crisis marked by external deficits and a liquidity crunch.

HOW WE ARE POSITIONED

We remain underweight China, but to a much smaller degree than in recent quarters.

The market's excess optimism of the last few years, marked out by valuations and market leadership, seems to have ended completely. Consensus is very negative towards China and Chinese equities.

No catalyst has yet emerged, and to be early is to be wrong, but conditions are supportive for whenever the change comes.

Source for all data JOHCM/Bloomberg (unless otherwise stated)