



All You Need Is Confidence

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China's services-led recovery is losing momentum. While mobility has rebounded, the economy remains saddled with low private sector confidence, high savings, no sign of inflation, and an elevated unemployment rate. The root causes of the disappointing recovery look increasingly structural with both households and corporations facing high debt and low confidence, still scarred by COVID controls, policy uncertainties, and regulatory crackdowns. China is under deflationary pressure and risks a balance sheet recession with private sectors deleveraging and repairing balance sheets, rather than maximizing profits. Monetary and credit easing do not help much if credit demand is low.

In addition, China faces various policy constraints when it comes to potential economic stimulus. One is the urgency to defuse financial risks in the property and local government funding vehicle (LGFV) sectors. Others include addressing worsening demographics, solving high youth unemployment, developing technology self-sufficiency, and ensuring national security in an adverse geopolitical environment. How these policies and their efficacy play out will determine whether the recovery will be more L-shaped than V-shaped. Furthermore, a sustained recovery remains contingent on job market improvement, stronger private sector confidence, and increasing external global demand.

Assessing various growth drivers will help us diagnose this weak recovery:

- Consumption remains below pre-COVID levels. As consumers continue to deleverage and repair balance sheets, the savings rate has surpassed pre-COVID levels (see [Exhibit 1](#)). Confidence rebuilding is key for the release of savings. Over the past several years, layoffs, salary cuts, regulatory actions against internet platforms and several industries, and fewer high-paying services jobs have caused acute unemployment for younger labor force cohorts and slowed the expansion of the middle class. Skill mismatch is another reason the youth unemployment rate exceeds 20%, according to Macrobond data.

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China Consumer Confidence and Savings Rate

% (Right), Index (Left), As of 3/1/2023

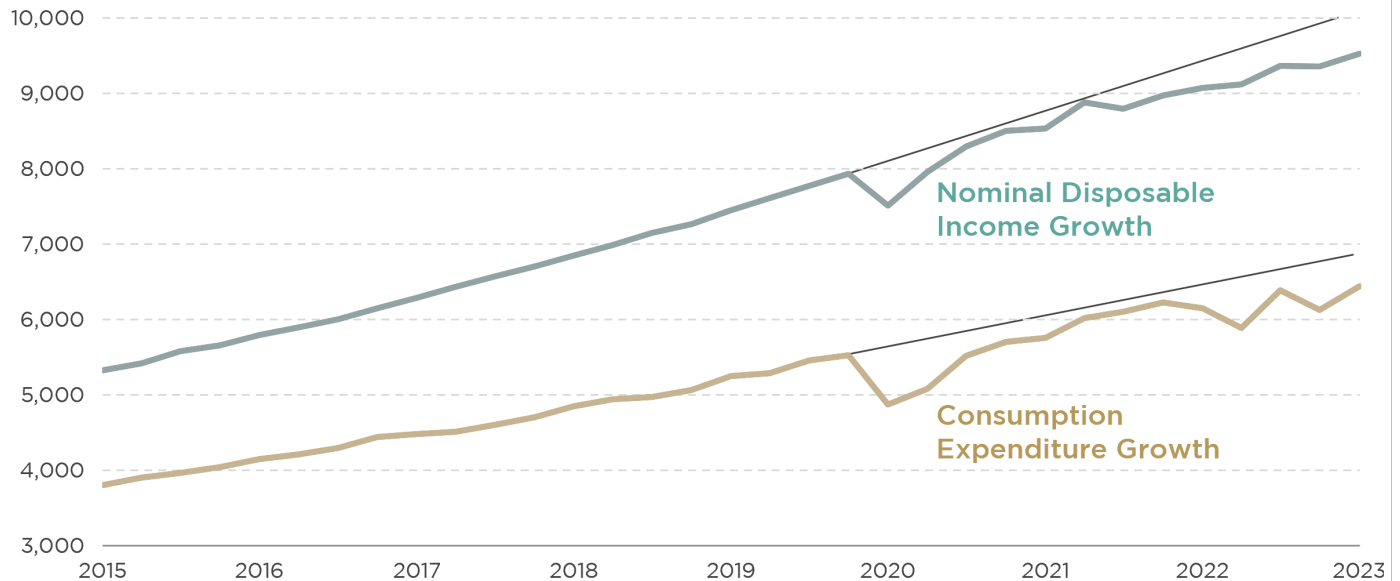


Source: Brandywine Global, Macrobond, National Bureau of Statistics (@ 2023)

The headwind for consumption renormalization is that income growth has been lagging gross domestic product (GDP) growth as reported by the National Bureau of Statistics. In turn, consumption growth further lags income growth. According to data from JP Morgan as of June 15, 2023, the household sector has accumulated RMB4.5tn (US\$600bn) of excess saving since 2020. Households lost income during the COVID years, but they grew savings by cutting spending even more (see [Exhibit 2](#)).

China Household Disposable Income vs. Consumption

CNY, Seasonally Adjusted, As of March 31, 2023



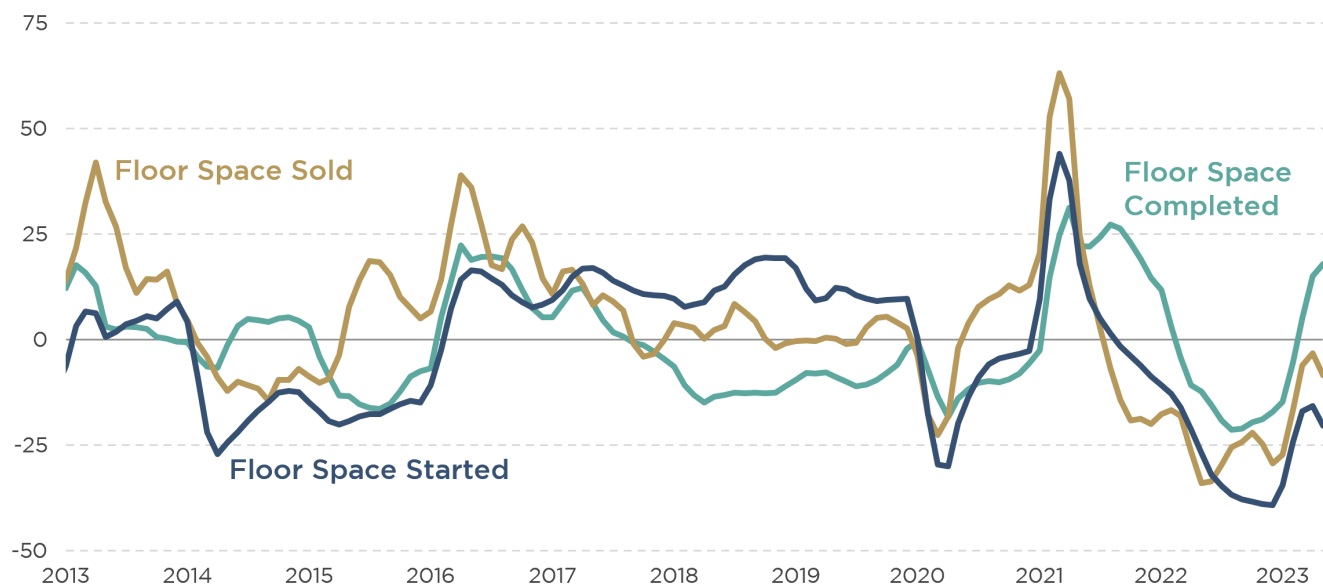
Source: Brandywine Global, Macrobond, National Bureau of Statistics (© 2023)

China's troubled property market resumed its slump. A rebound in the sector was very short-lived, despite continuously declining mortgage rates and measures enacted by local governments to support housing purchases. Land purchases and new starts are still contracting (see [Exhibit 3](#)), which points to private developers focusing on balance sheet repair rather than new investments. Meanwhile, households' sensitivity to demand-side housing measures appears to have declined significantly, impaired by home delivery concerns, loss of income, job uncertainties, and pessimistic property price expectations. Mortgage credit growth is still stalling, evidence of the drop-off in home sales, and developers' access to property loans still looks bleak (see [Exhibit 4](#)). Housing inventory is still elevated in lower-tier cities, and more cities reported month-over-month housing price decreases in May than in April, based on the China Real Estate Index System (CREIS) database. Despite many stimulative measures to support the property market and some housing upgrade demand, we believe the structural decline is inevitable due to China's shrinking population and slower urbanization pace. Our base-case scenario is that the property market will remain a drag on China's economy in the second half of 2023.

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China Real Estate Market Activity

% Year-over-year, 3-month moving average, As of 6/21/2023

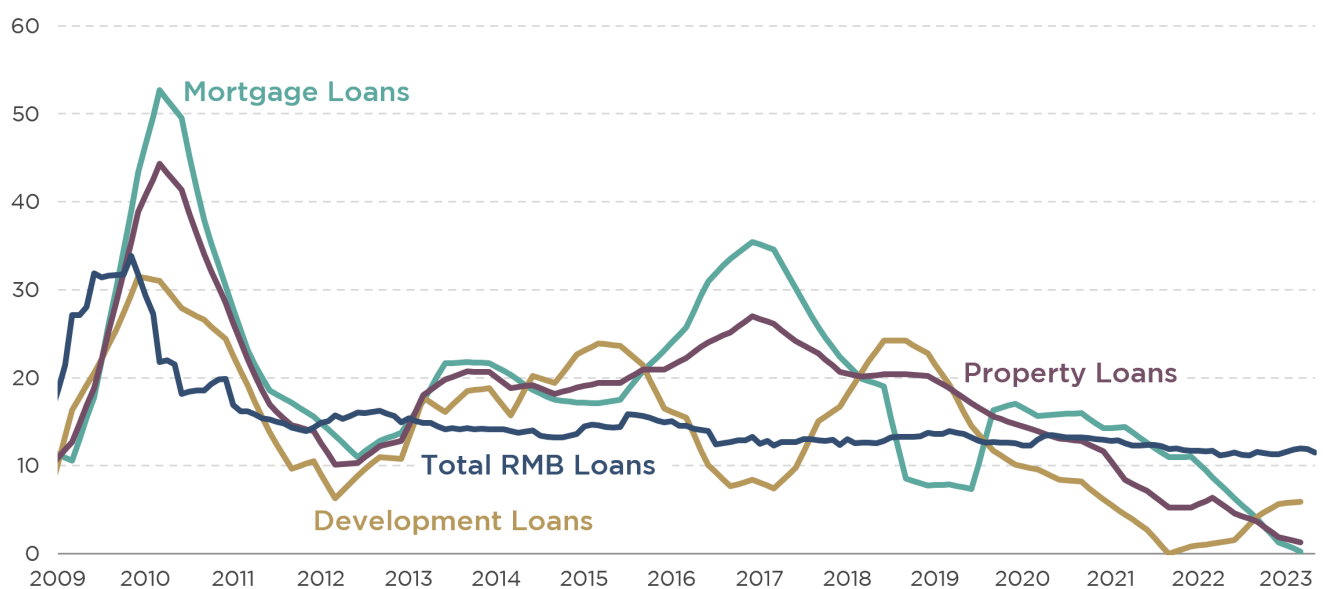


Source: Brandywine Global, Macrobond, National Bureau of Statistics (© 2023)

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Outstanding Property Sector Loan Growth vs. Outstanding RMB Loan Growth

% Year-over-year, As of 5/1/2023



Source: Brandywine Global, Macrobond, People's Bank of China (© 2023)

▣ Fixed asset investment (FAI) by state-owned enterprises (SOEs) crowded out private sector spending. This

trend suggests low-quality growth since SOE projects are typically government—not market—driven (see [Exhibit 5](#)). Infrastructure FAI will likely slow as struggling local governments cut back fiscal support. June's Caixin China manufacturing PMI fell to 50.5 from May's 50.9 reading, indicating the modest expansion in manufacturing and new orders slowed. We expect the soft manufacturing data will result in lower manufacturing FAI, weaker exports, low capacity utilization, ongoing destocking, and slump in industrial profits. We believe private sector confidence needs to improve for restocking to take off.

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Fixed Asset Investment Growth: Public vs. Private Sectors

% Year-over-year, 3-month moving average, As of 5/2023



Source: Brandywine Global, Macrobond, National Bureau of Statistics (© 2023)

- China's net exports also continue to face headwinds. These pressures on growth include a push by other countries to relocate supply chains, geopolitical tensions, and a slump in global manufacturing. We would expect commodity imports to pick up modestly. However, a bigger increase, encompassing a broader range of commodities beyond mostly oil, likely depends on a larger recovery in the property sector. Supply chain reshuffling and geopolitical tensions are headwinds to exports, weighing on corporate confidence and capital expenditures (capex). China's balance of payments is still solid with a robust current account, although we may continue to see a narrowing goods trade surplus, wider services deficit, and capital outflows, based on our analysis of data from the National Bureau of Statistics and Macrobond.

Stimulus measures are coming, but curb your enthusiasm

As the recovery continues to falter, we have already seen interest rate cuts and some marginal loosening of property market policies. But any expectations for a large stimulus may meet with disappointment. Given that local government debt already represents a significant portion of GDP, and private credit demand, as mentioned above, remains low, a large stimulus may only exacerbate China's structural problems while not helping much on the cyclical front. Furthermore, Chinese policymakers are likely to remain vigilant on financial stability risk and inflation risk to avoid gearing up recklessly again. We may see further targeted stimulus measures, but those measures must be forceful and address the loss of household income and confidence of the private sector. Otherwise, they likely will prove to be ineffective, and any resulting market rally short-lived.

- We expect monetary policy to be accommodative with more benign credit policy and abundant liquidity. However, we believe the room for further policy rate cuts is limited, which means the ability to boost demand may continue to fall short.
- After decades of infrastructure overbuilding, lack of land sale revenues, COVID-control spending, and other factors, China is facing a Local Government Funding Vehicle (LGFV) credit crunch along with a rising maturity wall. Bloomberg estimates there is US\$9.5 trillion outstanding, or approximately 48% of GDP. The LGFV problem has severe regional disparity with western provinces under more pressure. While the Chinese government, with little tolerance for defaults, may partially support the refinancing via policy banks and debt swaps, if necessary, we expect most of the resolution will be left to local governments via debt restructuring. The potential impact of LGFV credit stress could be a continued drag on infrastructure and property investments.

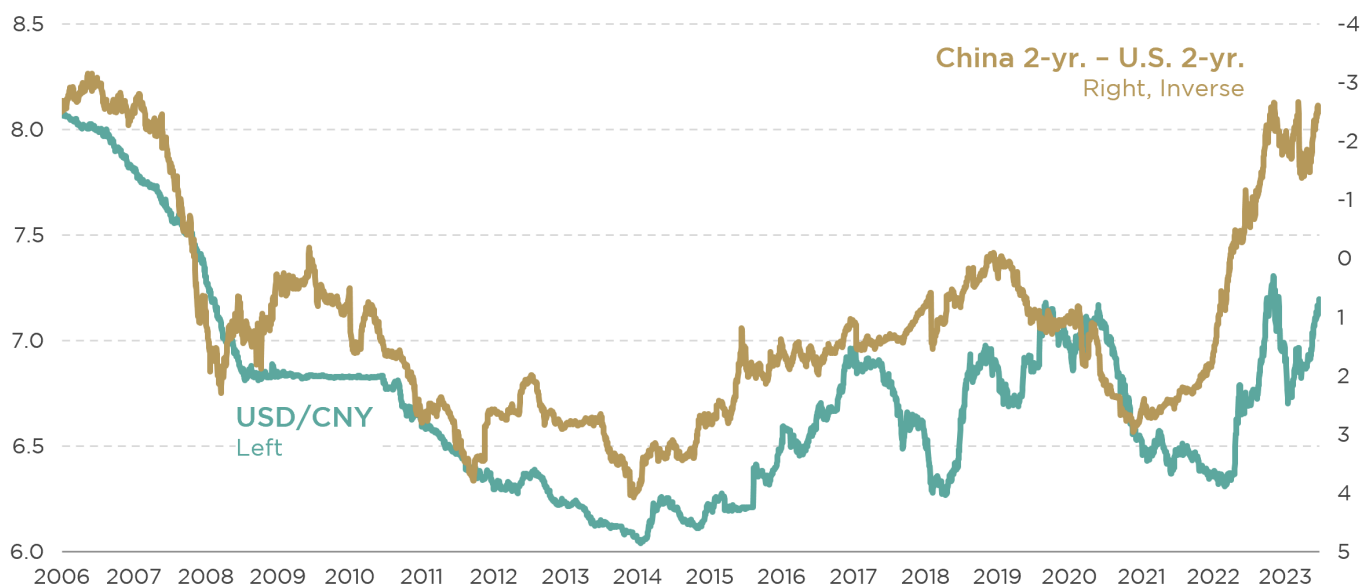
Investment implications:

- The yuan (CNY) faces further depreciation pressure against both the U.S. dollar (USD) and the China Foreign Exchange Trade System (CFETS) Currency Basket, driven by the increasingly negative interest rate differential between Chinese government bonds and U.S. Treasury bonds (see [Exhibit 6](#)). Downward pressure on CNY could also come from further rate cuts, net foreign direct investment (FDI) and other capital outflows, a shrinking current account surplus, and a host of other factors.

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China Government Bond - U.S. Treasury 2-Year Spread vs. USD/CNY

% (Right), U.S. Dollar per Chinese Yuan, As of 6/21/2023



Source: Brandywine Global, Macrobond (© 2023)

- Chinese government bond (CGB) yields have rallied this year, and the yield curve has steepened, outperforming most developed market sovereign bonds this year, based on Bloomberg data. Slower growth, disinflation, and expectations for near-term easing should be duration positive. Defusing risks in the property market and in LGTV debt requires easy liquidity conditions, which is positive for CGB. Weak credit demand and low private sector confidence, along with the structural headwinds facing China's economy, will likely mean CGB yields stay lower for longer.
- Support for global growth from China may be limited in the second half of 2023, particularly for

commodities demand and related emerging market risk assets. However, China's service-driven recovery should be relatively constructive for economies and sectors exposed to Chinese tourism, consumption, and services.

- Some emerging market countries may benefit from reshoring supply chains out of China. Mexico, Malaysia, Indonesia, and Vietnam are cases in point.
- Asian countries that are often viewed as proxies for Chinese investments, like Japan, may also benefit should China's recovery gain momentum later this year.

Conclusion

China's recovery has lost momentum, becoming more disinflationary over lost confidence and legacy structural problems. There is no sign of forceful targeted stimulus or structural reform that can quickly fix the confidence problem, which is at risk of becoming entrenched and self-fulfilling. Medium- and long-term risks remain for economic growth, including weakening credit demand, policy uncertainty, geopolitics, and other hurdles. Some priorities, like defusing risk in the property market and local government debt, may take priority over boosting low-quality growth.

There is no undervalued valuation anomaly seen in CNY or CGB, according to our valuation models. We believe CNY will continue to face depreciation pressure. While CGBs, given their strong performance this year, appear rich, they could prove to be a safe haven if China's growth continues to disappoint. We are still in the "lower for longer" camp for CGB yields. Generally, however, we see opportunities in other emerging markets and sectors, particularly those exposed to supply chain offshoring away from China and those tied to China's services-consumption sectors, which could benefit more than those with exposure to commodity sectors.

Index Definitions

China's National Bureau of Statistics produces the China Consumer Confidence Index, which is based on a poll of 700 individuals over 15 years old from 20 cities across the country. The index assesses consumer confidence in China on a scale of 0 to 200, with 200 indicating extreme optimism, 0 suggesting extreme pessimism, and 100 denoting neutrality. The consumer survey contains standardized questions about the financial situation of households, general economic situation, inflation, unemployment, saving, intentions of making major purchases on durable goods or purchasing or building a home or buying a car.

The Caixin China Manufacturing PMI is a composite indicator designed to provide an overall view of activity in the manufacturing sector and is derived from a survey of around 650 private and state-owned industrial companies. The Manufacturing Purchasing Managers Index is a weighted average based on five individual indexes with the following weights: New Orders (30 percent), Output (25 percent), Employment (20 percent), Suppliers' Delivery Times (15 percent) and Stocks of Items Purchased (10 percent), with the Delivery Times index inverted so that it moves in a comparable direction.

The China Real Estate Index System (CREIS) is a widely recognized index representing the housing market in China, compiled by the National Statistics Bureau and based on a sampling of properties from 70 cities, expanded in 2005 from 35 cities. The index covers new commodity housing.

The China Foreign Exchange Trade System (CFETS) currency basket includes CNY versus foreign exchange currency pairs listed on CFETS. The sample currency weight is calculated by the international trade weight with adjustments of re-export trade factors.

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