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China's policy pivot marks a turning point in the economic cycle

From the Field
December 2024

Key Insights

- The September Politburo meeting signaled a policy pivot from risk control to growth support. We expect a more favorable environment for growth and business.
- Immediate policy focus is on property and local government debt to stabilize the economy. Over the medium term, consumption and industrial upgrades hold the key.
- We see compelling opportunities in high-quality growth businesses, industrial companies that appear to be in an upcycle, and companies that have had rising shareholder returns.

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Decisive policy shift from controlling risk to supporting growth

In our view, the Politburo meeting on September 26 signaled a clear change with respect to China's policy priorities. Since 2021, financial deleveraging and austerity were the primary agenda. However, facing weakening demand and a slowing economy, there is now a clear sense of urgency to support growth. We think a policy turning point was reached with the Politburo's strong rhetoric about the economy, the call to reverse the property sector decline, and the flurry of expansionary policies that followed.

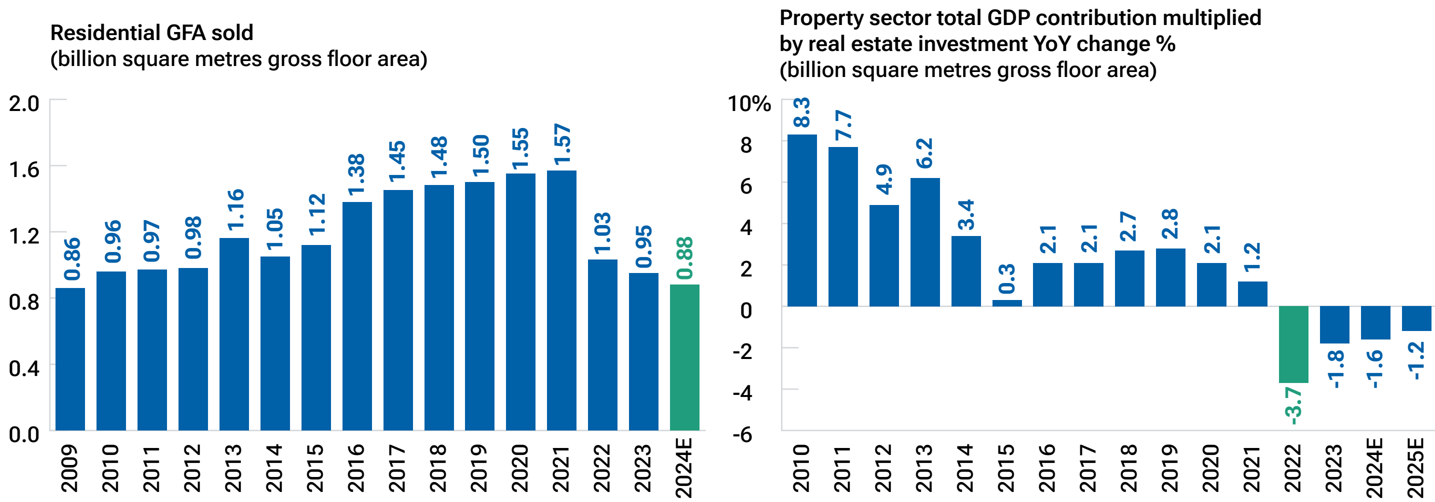
The first set of announcements from the People's Bank of China (PBOC) and other financial regulators were centered on monetary policy easing, including interest rate cuts, a reduction in the required reserve ratio for banks, lowering the cost for existing mortgages, and targeted support for the equity market. Subsequently, the Ministry of Finance came out with announcements regarding fiscal support, with the initial priorities being local government debt, property destocking, and increased spending on the safety net for low-income groups.

The market is currently laser-focused on the specific size of the fiscal budget. We believe the directional change is what matters. With the strong commitment to support growth, we may now have the "policy put" in place. More support is likely to come if the initial phases prove to be insufficient. In addition, with the clear message from Beijing, the local governments' mentality will shift. This will create a more favorable policy environment at the local and execution levels.

Current financial deleveraging cycle enters late innings

China's economic recovery since the COVID reopening has disappointed. While there are structural challenges, we believe that the deleveraging cycle since 2021 was the dominant factor accounting for the weakness. The agenda was to address the overinvestment and overpricing in the property sector. From the peak in 2020, the price of secondary homes declined 30%, primary sales volume more than halved, and new housing starts declined by over 70%. The negative impact on the Chinese economy

(Fig. 1) Property sales volume back to 15 years ago



As of August 31, 2024.
YoY = Year-over-year; bn sqm GFA = billion square metres gross floor area.
E = Estimates. Actual future outcomes may differ materially from estimates.
Source: Citi Research.

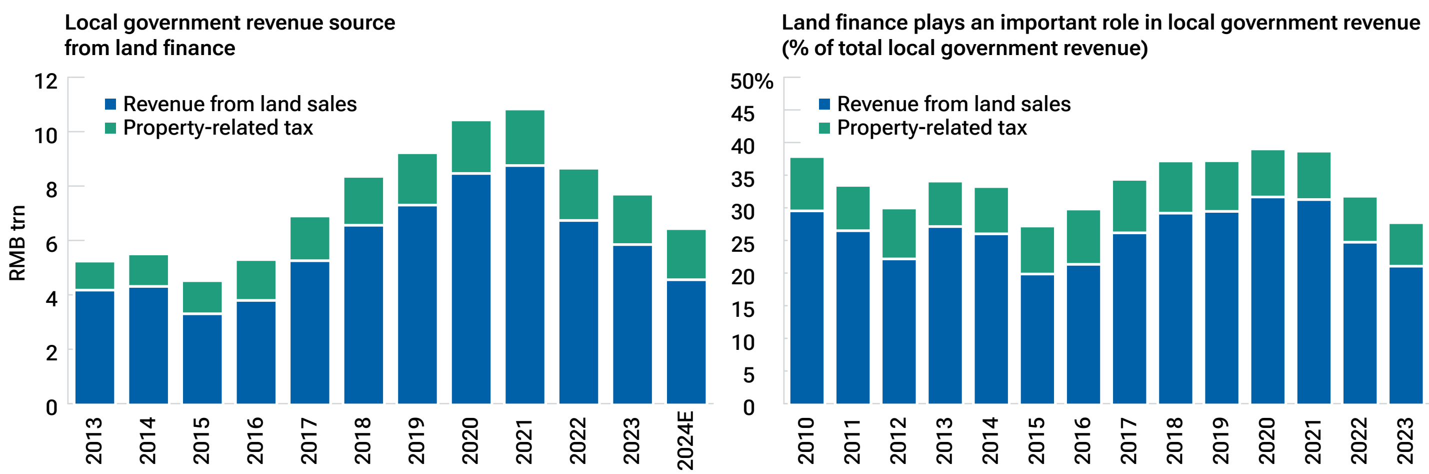
was significant, though the worst might be behind us. With China's property investment as share of total investment normalizing to around 9% to 10% (around the average for developed market economies), the industry is now on a more sustainable footing than it was three or four years ago (Figure 1).

China's property slump resulted in the deterioration of another ongoing chronic problem—local government debt. Land finance was close to 40% of local government revenues in 2020. However, this revenue source has since declined by over 40% (Figure 2).

The result of this is a declining willingness by local government to invest, an austerity mentality taking hold, and a less friendly business environment.

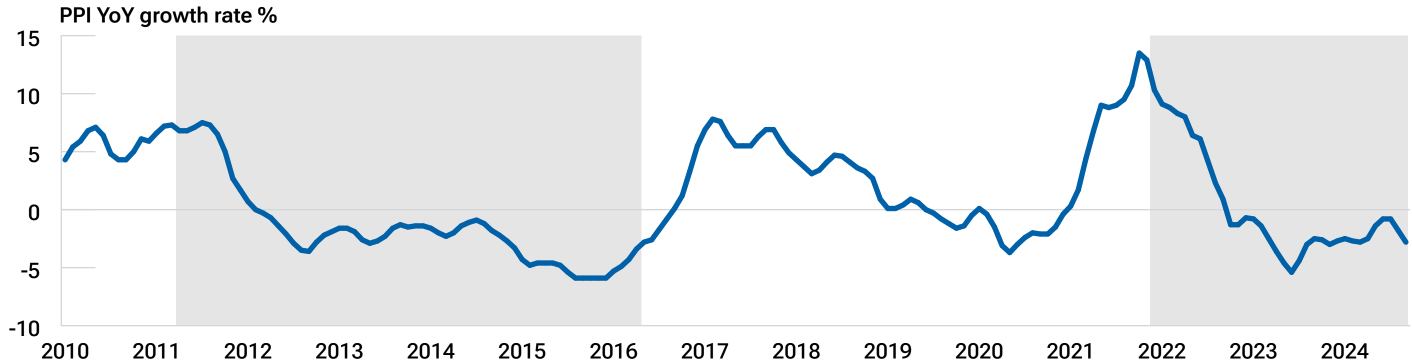
To better understand the current trajectory, it would be helpful to review the last deleveraging cycle in 2011–2015. China's huge stimulus in response to the global financial crisis (GFC) in 2008 led to significant overinvestment in infrastructure and overcapacity in upstream industries. A weak producer price index (PPI) was a symptom of that cycle, with the annual change in the PPI in

(Fig. 2) Local government and land finance in China

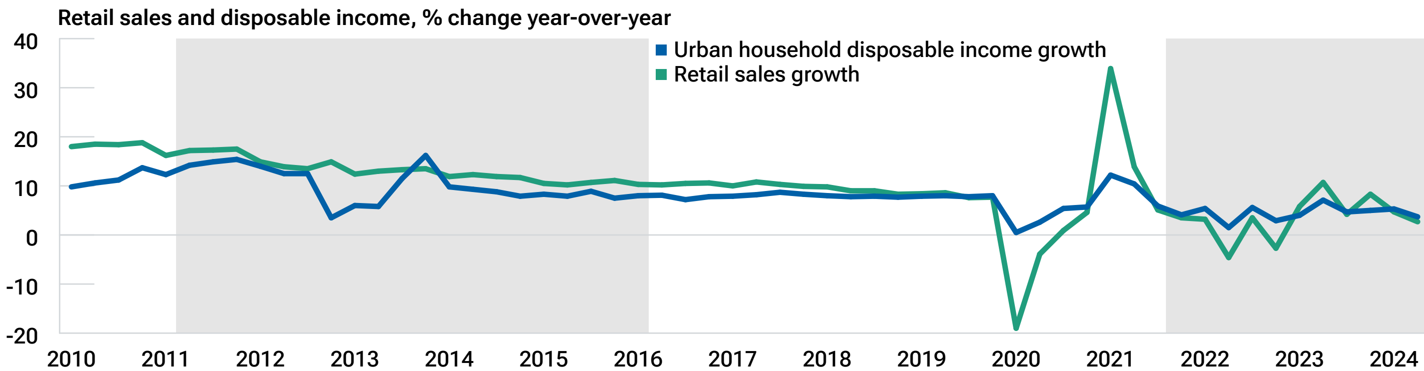


As of July 2024.
RMB trn = Renminbi trillion.
Revenue in 2024 is estimated using realized revenue growth in July year-to-date. Actual outcomes may differ materially from estimates. Estimates are subject to change.
Sources: Wind, Nomura Global Economics.

(Fig. 3) Weak consumption and deflation pressures are symptoms of China's slowing economy



As of September 2024.



As of June 2024.
YoY = Year-Over-Year.
Grey shaded areas equal sustained periods of weak consumption and PPI deflation pressure.
Source: Bloomberg Finance L.P.

negative territory for four consecutive years. On the other hand, consumption spending was holding up quite well back then. This round of deleveraging since 2021 is different. It had a significant impact on the property sector supply chain and a negative wealth effect on households. The symptom is weak consumption and deflation pressure (Figure 3).

Recent policy announcements directly target the weak links in the Chinese economy of property, local government debt, and consumption. We expect these initiatives to stop the negative feedback loop and put the economy back on a stable path over the coming quarters.

China's long-term economic transition remains intact

The near-term policies focus on the imminent challenges of property and local government debt. However, China also needs new drivers to sustain high-quality growth over the mid- to long term. We expect a gradual shift away from traditional fixed asset investment-driven growth.

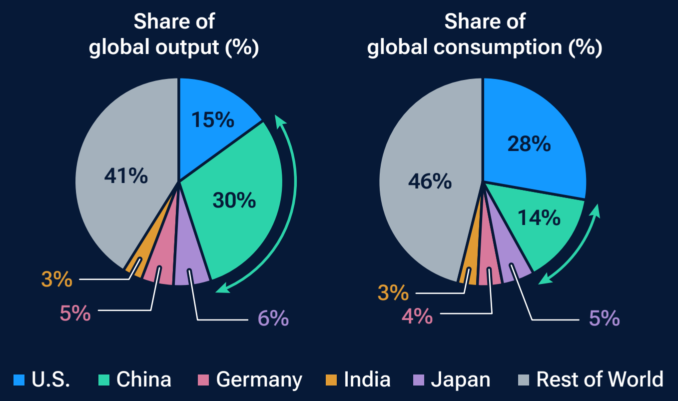
Over the past three decades, China has experienced four economic downturns. Each time, a new growth driver has emerged afterward. After the Asian financial crisis in the late 1990s, it was an export boom in the early 2000s; following the global financial crisis in 2008, it was increased infrastructure investment; the 2014–2015 downturn was followed by the property market boom. Looking ahead, we expect consumption and industrial upgrading to be the key factors that help to drive China's next phase of economic growth.

Currently, China's private consumption is less than 40% of gross domestic product, significantly below most other major economies. However, we think this could start to change. The Chinese government's agenda has started to shift away from "hard infrastructure" to an emphasis more on "soft infrastructure." That includes new urbanization, the social safety net, education, health care, and child-care. These trends should be supportive of increasing consumption over the coming years.

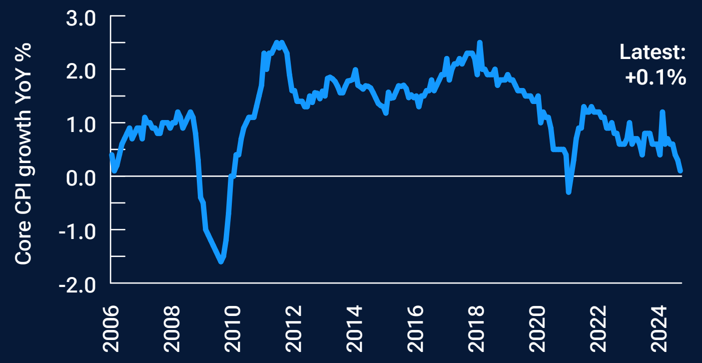
Technology and industrial upgrades are another key driver, both domestically and in the global market. China already accounts for over 30% of global manufacturing output. The future is more about increasing value added than pure volume. The effect of China's

(Fig. 4) Consumption: Diverging trends

Manufacturing vs. Consumption



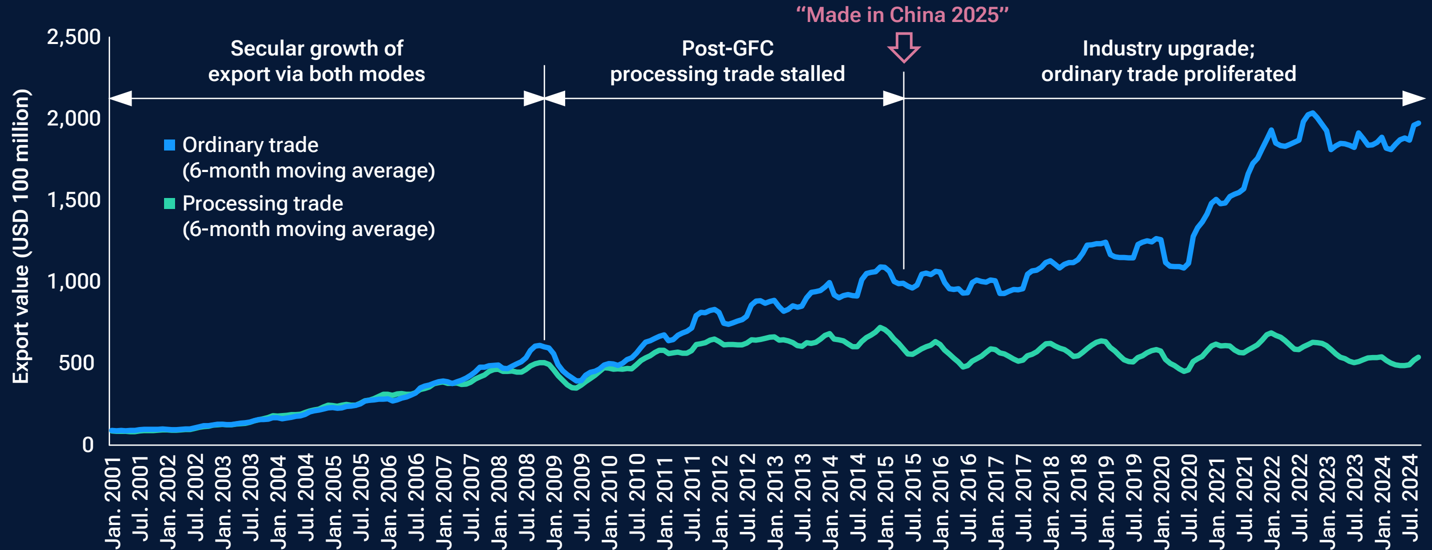
China core consumer price index (CPI)
China's core CPI growth fell sharply in Q3 to just +0.1% YoY in September from +0.6% in June



As of August 31, 2024.
Sources: World Bank, NBS, BEA, CAO, Deutsche Bundesbank, Ministry of Statistics and Programme Implementation (India), Haver Analytics, CEIC, Citi Research.

Ordinary trade and processing trade show diverging trend in China's export

(Fig. 5) China export via ordinary trade and processing trade



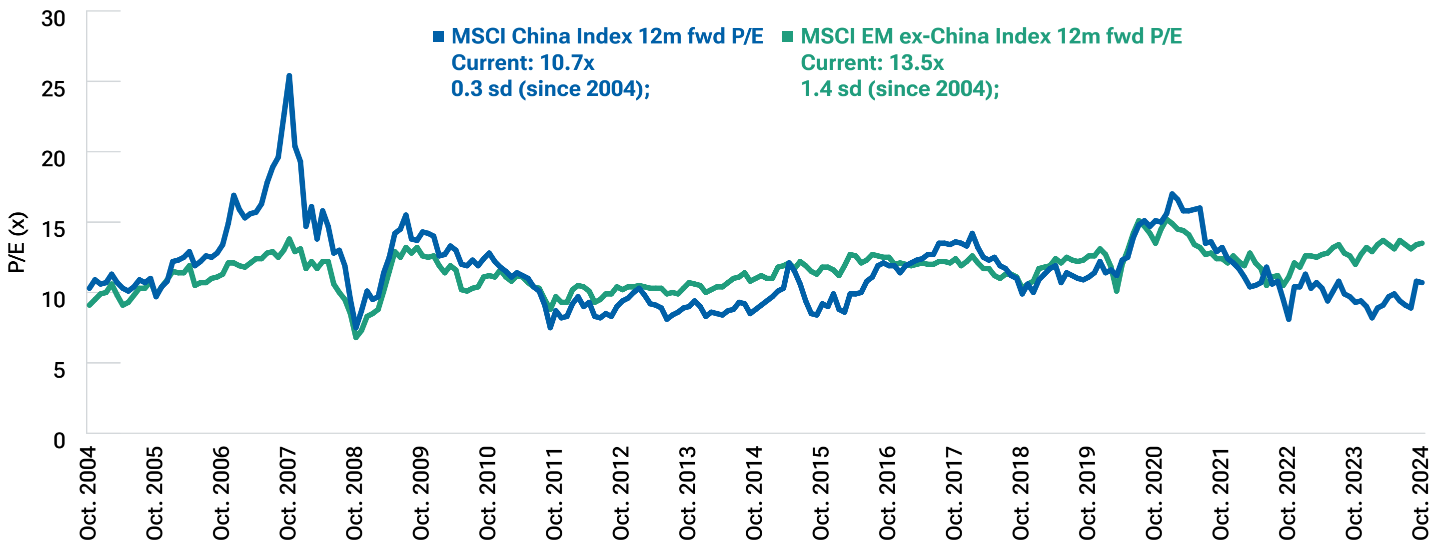
As of September 30, 2024.
Processing trade is where materials and components to be used in export production are imported into China under bonded status, free of tax.
Ordinary trade = Chinese exports that are part of processing trade.
Made in China 2025 is a government policy to increase the Chinese-domestic content of core products to 40 percent by 2020 and 70 percent by 2025.
Sources: Wind, China Customs, Bernstein Research.

industrial upgrade is well reflected in its export mix. China's processing trade had declined over the past decade, but the ordinary trade, which carries much higher value added, more than doubled during the period.

After the PBOC's announcement on September 24, the MSCI China Index rallied by over 30% in the following two weeks. This was followed by a 10% pullback when the market reopened on October 8 after China's weeklong national holiday. We think economic improvement and a corporate earnings inflection are probably still two to three quarters away. The market currently is mostly trading on sentiment and policy expectations. Despite near-term volatility, we see an improving outlook and attractive valuation. We are constructive on the outlook for Chinese equities over the next two to three years.

Past performance is not a reliable indicator of future performance.

(Fig. 6) MSCI China's forward P/E has rerated near its 20-year historical average from oversold levels



As of October 11, 2024.
SD= Standard deviation. P/E= Price-to-Earnings, using 12 month forward earnings. Actual outcomes may differ materially from estimates.
Sources: FactSet, MSCI, Goldman Sachs Global Investment Research.

With the recent market recovery, MSCI China's price/earnings ratio has rerated to near its 20-year average but remains at a 20% discount to emerging markets ex-China (Figure 6). After this broad-based rerating, we think corporate fundamentals will be the key performance drivers going forward. From a bottom-up perspective, we can continue to find compelling investment opportunities in China's deep, stock market.

After three and a half years of market downturn and underperformance of growth stocks, select high-quality growth stocks in China are trading at an attractive price. We continue to like our holdings in online recruiting, shopping malls, and hotel chains. These are scalable businesses with high earnings growth potential over the next few years. We believe they also stand to benefit from an improving macro outlook.

Another fertile hunting ground is industrial businesses with strong competitiveness and a favorable industry cycle. Examples include rail equipment, power grid upgrade, shipbuilding, and construction machinery. We expect these businesses to see accelerating earnings growth and improving returns over the coming quarters, with or without additional policy stimulus.

There are increasing opportunities for rising shareholder returns. In select industries, as businesses mature they enter the "harvest stage" and become highly cash generative. We look for Chinese companies with a combination of rising cash flow, disciplined capital allocation, and shareholder-friendly mindset. We have found that combination in our holdings of telecom tower, outdoor media, and delivery companies.

Conclusion

China's economic policy has reached the turning point from deleveraging to growth. This increased policy support could stabilize the economy by effectively addressing the property sector and local debt issues. We believe the transition to consumption and industrial upgrading will, over time, drive the next phase of China's economic growth. We continue to find compelling opportunities in Chinese equities. We aim to build a balanced fund that will benefit from China's economic transition in the coming years.

Financial Terms: For a Glossary of financial terms that may have been used in this material, please go to:
www.troweprice.com/en/us/glossary

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