Weekly Market Flash

China's Long Game

March 28, 2024

A few weeks ago we used this space to write about China and India, the two largest countries in the world by population that both figure prominently into the global economy. If you recall from our commentary that week, India's stock market has been going gangbusters while China's has brought nothing but disappointment to those looking for a portfolio win from there. Not surprisingly, therefore, there has been a good deal of chatter among market pundits recently encouraging investors to get on board the India train. It's easy to tout the benefits of a trade when that trade is enjoying a hot streak of outperformance. It's something else entirely to back a long shot. And make no mistake, the investment case for China today is a long shot. It's not something we are prepared to commit any serious money to today. But there is a case to be made – and to be followed closely, if not necessarily acted on yet.

In Need of Something New

The main problem China's economy faces today is that its primary engine of growth for the past 30-plus years is in dire straits. Property and infrastructure investment, in fact, has been the single most important driver of economic performance throughout the entirety of the country's development following the death of Mao Zedong in 1976. But in the past three years this sector has completely unraveled, with the failures of several of the largest property developers and, consequently, a sharp retrenchment in housing starts and other relevant measures of health. The saga of Evergrande, one of those failed property developers, played out like a bad soap opera for three years until a Hong Kong court finally enforced a liquidation on what remained of the bankrupt company back in January. A general rule of thumb is that the property and investment sector contributes about a third of China's total GDP. So if this sector is going into reverse, what new thing is going to enable Beijing to meet its commitment to growing the economy by at least five percent every year?

Clean High Tech Manufacturing

The answer, made abundantly clear in a state of the nation report Prime Minister Li Qiang gave earlier this month and since repeated incessantly in the Chinese press, is high tech manufacturing, with a deep focus on clean energy. On one level this makes a great deal of sense. China already leads the world in some important green technology segments including solar panels, batteries and electric vehicles. Late last year the country's largest EV manufacturer, BYD, surpassed Tesla as the world's leading producer of fully electric cars and trucks. This year, the share of China-made EVs in the European market is expected to surpass 25 percent, unless the EU slaps some hefty tariffs on imports. China also is way ahead of the rest of the world in the extraction and refining of most of the key raw materials needed for clean energy manufacturing. As the world tries to move away from dependence on fossil fuels, China stands to be the country setting the pace and reaping the lion's share of the benefits.

But Where Is The Consumer?

That's a big part of the investment case. But the case has some big risks, as well. For a start, the obsessive focus on manufacturing as the growth engine does not deal much at all with another big problem in China's economy – the lack of a vibrant consumer sector. Household consumption contributes less than 40 percent towards China's total GDP. The comparable figure in the US is close to 70 percent, and it is around 55 percent in the EU. Back in the middle of the 2010s Beijing's economic authorities tried to orchestrate a rebalancing of the economy away from property and infrastructure towards household consumption. But a sharp currency devaluation and subsequent economic slowdown in 2015 brought that plan to halt, and Beijing went right back to the old standby of property. There's a trajectory from that decision to the failures of Evergrande and its ilk more recently. It is far from certain that China can achieve a sustainable growth story on the back of high tech manufacturing alone, without the help of a strong consumer sector.

The second big risk is geopolitical. China may well continue to lead the world in all things clean tech, but it won't matter much if other markets around the world put up massive barriers to Chinese imports. There is a good reason why Xi Jinping dragooned a bunch of US CEOs, in Beijing this week for an annual business conference, into a heavily publicized meeting in the Great Hall of the People to tell them not to give up on the very wonderful opportunities that China's future will offer them. Xi knows that US political opinion is not working in China's favor, and he will need all the help he can get from the titans of the private sector to counter the high tariffs and other barriers contemplated by current and future administrations in Washington.

So there it is. As with any investment decision there are risks and opportunities. We continue to believe that the risks outweigh the upside, but we also believe that the opportunity demands continued study.

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