China on the road to Japan

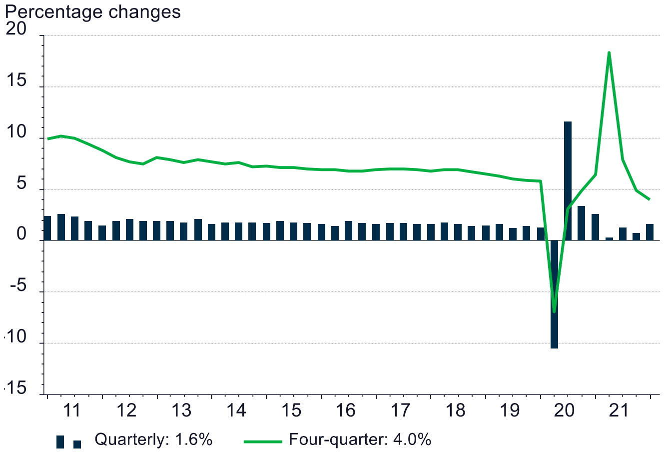
11 February 2022

Jonathan Ashworth

China's economy expanded by an impressive-looking 8.1% in 2021, according to official data. This came after growth of just 2.2% in 2020 amid the onset of COVID-19, and an average of 7.7% in the previous decade. Headlines can be deceiving, however. Strong growth last year was largely a result of highly favourable statistical carry-over effects - quarterly annualised growth averaged just 4% in 2021. The year-on-year pace of growth also slowed sharply in the second half of the year. Fathom's China Momentum Indicator, which is our estimate of China's true underlying growth rate, has also slowed sharply. Unless there is a material change in policy, away from Xi's 'jam today' approach, we believe China is headed for Japanification.

China GDP

Percentage changes

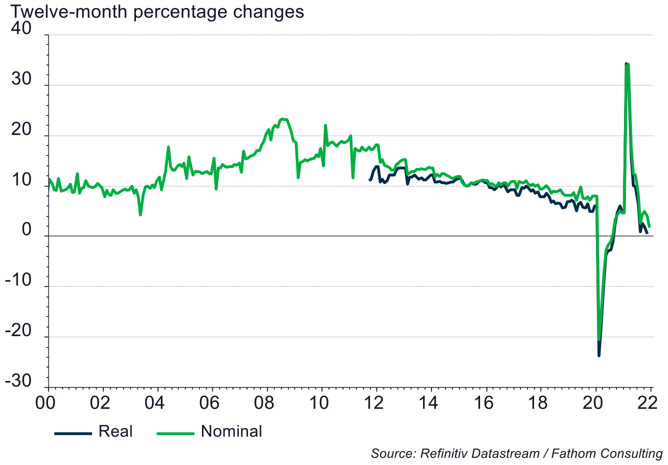


Source: Refinitiv Datastream / Fathom Consulting

Various factors have been weighing on the economy. Key have been the government's draconian zero-COVID strategy and the intensification of the Evergrande crisis, which have had large negative impacts on the consumer and the housing market. Nominal retail sales growth slowed to just 1.7% on a twelve-month basis in December, while in the fourth quarter the floor area of residential buildings started and sold was 30% and 20% lower respectively than the year before.

Continued

China retail sales

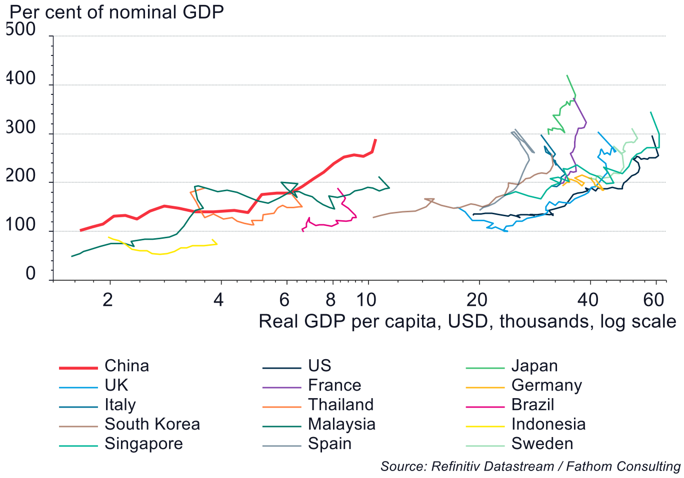


Beijing's concerns about the economy's weakness seemed to intensify towards the end of last year, and economic stability was a key theme of the government's annual Central Economic Work Conference in December. The People's Bank of China has recently eased policy, and special bond quotas were issued to local governments in December which will be used to boost infrastructure spending over coming months.

Further policy easing is likely, including measures to stabilise the housing market. President Xi will not want to take any chances in a year when he is hoping to secure an historic third term in office. Nevertheless, downside risks to growth - as discussed in more detail here - should not be underestimated, and these are likely to be reflected in this year's growth target, due to be announced in March. Annual growth targets have fallen over the past decade, a reflection of slower trend growth.

Looking beyond 2022, investors should brace themselves for much slower growth in China over the coming decade. Its policymakers face the unenviable challenge of reducing the risks associated with an over-inflated housing market while avoiding a sharp slowdown. Moreover, their ability to keep stimulating growth is limited by elevated, economy-wide debt levels. Ultimately, rebalancing and unwinding the excesses of the past is hard to do. It requires short-term pain for long-term gain, which typically proves too unpalatable.

Credit to non-financial sector

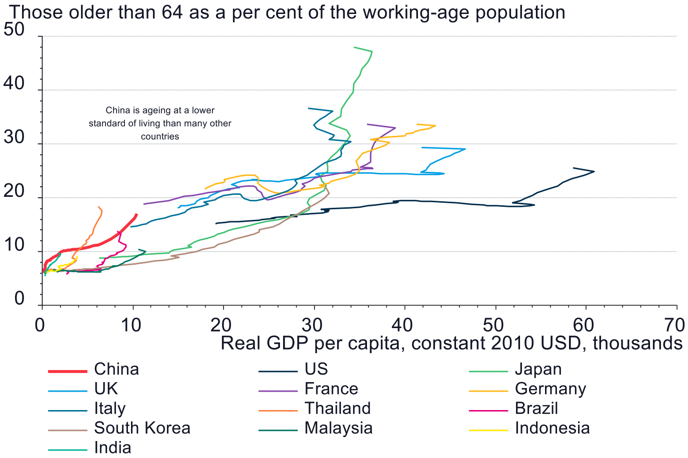


Continued

Meanwhile, Beijing's unpredictable and aggressive regulatory measures against key parts of the private sector in recent years, its increasing penchant for state control, and frayed relations with the West, are likely to weigh on domestic innovation.[1] These potential headwinds to productivity growth from weaker innovation will occur at a time when demographics are becoming decidedly less favourable. As the chart highlights, China is growing old before it grows rich, with its old-age dependency ratio rising at a much lower standard of living than elsewhere.

Standard of living and dependency ratio

Those older than 64 as a per cent of the working-age population



Source: Refinitiv Datastream / Fathom Consulting

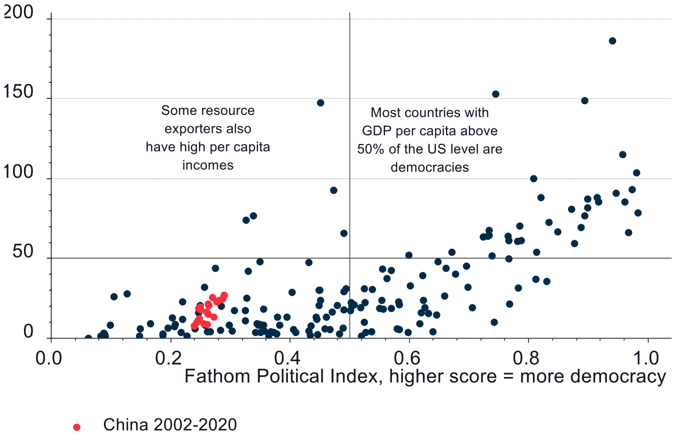
Furthermore, it tends to be democracies and resource-rich countries that succeed in making progress towards US levels of income per capita. China's policymakers are tugging in the opposite direction, exercising greater state control to control nagging COVID-19 outbreaks and tightening their grip more broadly in the economic and social realms. All in all, Fathom believes that China is headed towards Japanification — characterised by weak growth, low inflation and low interest rates. Hence, we continue to favour government bonds as the most attractive Chinese asset, a position we have held since Q1 2019. Any moves by Beijing to distract from the slowing economy through nationalist adventures could have implications for Taiwanese equities, as Fathom discussed in a recent research note, which can be accessed here.

1. The IMF suggests that the productivity gap across sectors between state-owned enterprises and private companies is around 20 per cent; see People's Republic of China: 2021 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for the People's Republic of China (imf.org)

Continued

Fathom Political Index and GDP per capita, 2020

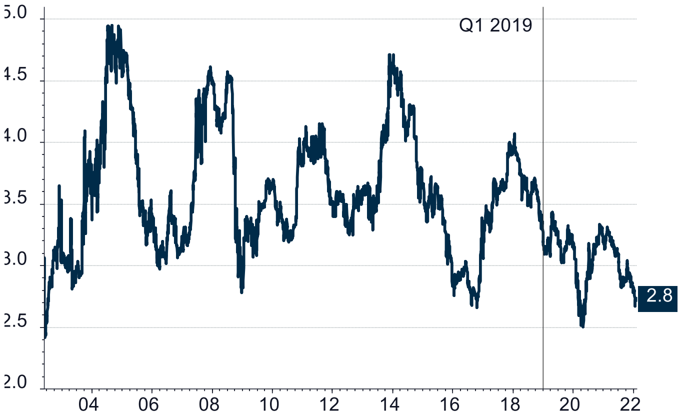
Per cent of US GDP per capita (PPP, IMF estimates)



Source: Refinitiv Datastream / Fathom Consulting

China ten-year government bond yield

Per cent



Source: Refinitiv Datastream / Fathom Consulting

Further reading

[China's house of cards]

[Where will Xi set the growth target for 2022?]

[Is Made in China really made in China?]

Fathom Consulting
47 Bevenden Street
London
N1 6BH
Tel: +44 (0)20 7796 9561

Contact information
jonathan.ashworth@fathom-consulting.com
www.fathom-consulting.com

Regulatory Disclaimer

FFC LIMITED and all of its affiliates (henceforth FFC) do not conduct “investment research” as defined in the FCA Conduct of Business Sourcebook (COBS) section 12 nor do they provide “advice about securities” as defined in the Regulation of Investment Advisors by the U.S. SEC. FFC is not regulated by the SEC or by the FCA or by any other regulatory body.

This research report has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. Nonetheless, FFC has an internal policy that prohibits “front-running” and that is designed to minimize the risk of receiving or misusing confidential or potentially material non-public information.

The views and conclusions expressed here may be changed without notice. FFC, its partners and employees make no representation about the completeness or accuracy of the data, calculations, information or opinions contained in this report. This report may not be copied, redistributed or reproduced in part or whole without FFC’s express permission.

Information contained in this report or relied upon in its construction may previously have been disclosed under a consulting agreement with one or more clients. The prices of securities referred to in the report may rise or fall and past performance and forecasts should not be treated as a reliable indicator of future performance or results. This report is not directed to you if FFC is barred from doing business in your jurisdiction. Nor is it an offer or solicitation to buy or sell securities.

Analyst Certification

I Jonathan Ashworth, the lead analyst, certify that the views expressed herein are mine and are clear, fair and not misleading at the time of publication. They have not been influenced by any relationship, either a personal relationship of mine or a relationship of the firm, to any entity described or referred to herein nor to any client of FFC nor has any inducement been received in relation to those views.

I further certify that in the preparation and publication of this report I have at all times followed all relevant FFC compliance protocols including those reasonably seeking to prevent the receipt or misuse of material non-public information.