

Exchanges at Goldman Sachs
How China's 'Perfect Storm' and Economic
Headwinds Are Affecting Markets and Investors
Hui Shan, Chief China Economist,
Goldman Sachs Research
Kinger Lau, Chief China Equity Strategist,
Macro Research, Goldman Sachs Research
Allison Nathan, Host
Recorded: April 25th, 2022

Allison Nathan Lockdowns in China, slowing economic growth, and ongoing supply chain bottlenecks. China has been at the forefront of investor conversations for years. But is it still investable?

Kinger Lau: We are in a perfect storm situation where we have a number of economic and regulation headwinds all going against the market at the same time.

Allison Nathan: I'm Allison Nathan and this is Exchanges at Goldman Sachs.

[MUSIC INTRO]

Allison Nathan: Against a challenging macroeconomic backdrop, investors are re-evaluating their exposure to China. To help us understand the outlook for China's economy and markets, I'm sitting down with two of my colleagues in Goldman Sachs Research, Hui Shan, our Chief China Economist, and Kinger Lau, Chief Equity Strategist in Macro Research.

Hui, Kinger, thanks so much for joining us.

Hui Shan: Good to be here.

Kinger Lau: Thanks, Allison.

Allison Nathan: China is our topic for this episode because it's facing multiple headwinds. We have COVID lockdowns, property sector worries, and geopolitical tensions, just to name a few. The lockdowns, in my mind, are front and center just because they have the potential to significantly slow economic growth in the country and prolong the supply chain disruptions that remain very much in focus. So, let's start there, Hui. What's your read

on the lockdown situation and the risks around it right now?

Hui Shan: Yeah, certainly. That's the number one question we're getting these days, especially when the rest of the world is opening up, whereas China's kind of stuck in this situation. I tend to emphasize that this is not really by choice in the sense that if you look at the elderly vaccination in China, it's still at relatively low levels, below 60 percent of the elderly population aged 80 and above have been vaccinated.

So, if the Hong Kong experience is of any guidance, that scares the policymakers and, frankly, a lot of citizens in China about opening up. So, we're stuck in this situation when omicron is very contagious, but we still have the Zero COVID Policy which, in turn, means a lot of restrictions and a lot of pressure on the economy.

What is really going on right now? What we are seeing and tracking daily information and varieties of indicators is that the number of cases is still very elevated. But at the same time, the number of places being impacted is declining. It's

highly uncertain. But we're seeing supply chains, for example, around the middle of April, we saw arrivals and departures at Shanghai ports, that was the lowest point. And after that, there is some sequential improvement. And similarly, within city traffic, congestion measures, and a few other indicators. So, my takeaway is that this is the worst wave since early 2020. The number of cases is still very high. We just got the news over the weekend about Beijing restricting activity because of cases. But so far, seems like we've seen, at least a local peak in cases, and activity showed a sequential improvement marginally.

Allison Nathan: And you track this in a lockdown index?

Hui Shan: Yeah. It's pretty amazing. Recall more than two years at the beginning of 2020, China had the highest lockdown. Meaning the lockdown was the most stringent in China versus ex-China. After that, for much of 2020 and 2021, China's lockdown index was much lower than the rest of the world. And coming into March/April, we're seeing another reversal. China, right now, has a lockdown index of around 40 and at its peak, February 2020, it was

at 80. Whereas everywhere else, it's more like a 10 - 20 lockdown index.

That's why a lot of people are asking is manufacturing moving out of China because before China had the stability and the advantage of producing, whereas other countries were battling with COVID outbreaks. And now we're risking seeing the reversal of that.

Allison Nathan: Let me switch gears for a moment to another key concern in the Chinese economy that has been a focus for a while now but seems to have fallen from the headlines: the property sector in China. Is that less of a concern? Or is it just getting less attention right now because of the shift and focus towards the lockdowns?

Hui Shan: Yeah. I think it's a bit like the market can only focus on one thing at a time. It's still a pretty stressful situation. In fact, the two negative shocks, the housing downturn and the COVID, interact with each other and reinforce each other. When you look at the January/February property sales that we're tracking, it was down 30 percent year on year. Not great. But come

March/April and we had this latest outbreak, now we're tracking close to 50 percent down year on year. So, you can imagine the central bank and maybe lowering mortgage rates. And cities may be relaxing purchasing restrictions. But if you can't go out of your apartment, it doesn't help. You don't have transactions.

And so, we're in this situation where before this latest outbreak we saw some green shoots and some hopeful signs of stabilization in property transactions. But now all of a sudden we've got another letdown in the transactions. This is, from a gross perspective, these are the two major drags to economic growth this year that is embedded in our forecast.

Allison Nathan: So, when we think about these major drags in growth, historically we are used to Chinese policymakers stepping in when they see growth threatened to this extent. Is that happening this time around? And if so, how much cushion could that provide to the blow of these factors?

Hui Shan: Previously, because of the planned nature of the economy or the government having a lot of control over the economy, policies tended to be this countercyclical buffer that if external demand isn't super strong, then the Chinese government can do less of policy support and still have stable growth. And vice versa. When the external demand is not good or other shocks happen, the government can provide support to the economy, typically via infrastructure building or property sector relaxation to keep the growth roughly within a reasonable range.

What's different now, I think a few things. One is that if you think back to 2008/2009 when the global financial crisis happened, that was an exogenous shock for China. The developmental stage is different now. Back then you had a lot of demand for infrastructure building, a lot of demand for people moving into these modern housing stock versus old, outdated, and poor-quality housing units. If you have that potential demand, you can tap into it to help out with your cyclical growth outlook.

Versus now, after, you know, ten, 15 years of very fast infrastructure building, a lot of apartment buildings being

put in place, you don't have as much or as potent of these demands you can tap into, you can stimulate and get a very robust growth impulse. That's number one. Number two, I think the current administration, if you think about the leadership of Xi Jinping, he's pretty into thinking about deleveraging. Even back in 2017/2018, the downturn was related to this idea of cracking down on shadow banking and controlling leverage. And if you think about this round, the housing sector was also, because of this push for deleveraging, we had this downturn. So, I think this is also different when you think back on previous leadership or previous administrations in China, you had a different mindset and they tended to be more on the deleveraging rather than providing support to the economy, lever up and let's get the economy going mindset.

And the third difference, I would say, is that because President Xi is aiming for a third term, so you could imagine he might be having an even longer-term view than previous predecessors, that if you were in the office for just another five years you might want to make sure the economy is going well. You want to stimulate. Whereas if you're going to be in office for another ten years, then what

you worry about is not just stimulating the economy and getting the growth number this year, you also worry about five years down the road. Are we going to have these financial imbalances and risks and future volatility and potential downturn? So, I think those are all the differences that are making this market and this investment environment more challenging than in previous cycles.

Allison Nathan: And is there kind of a silver lining from your perspective than that there isn't as much desire and instinct to go to leveraging again? That we think about the downturn in the property sector that was potentially very overheated. So, are we seeing a correction that was long and coming? I mean, can we take that away and say some of this will ultimately be good for the Chinese economy over the medium term even if near term it's generating some downside to growth?

Hui Shan: Yeah, I think that's right. I think the direction when we look at the numbers, population growth, and urbanization, a lot of these tailwinds are fading. So, from a demand, from the [UNINTEL] demand point of view, we do think the longer-term demand for housing is going to

decline. So, you want to engineer a soft landing. So, the direction should be a slower pace of growth or even fewer apartments being built each year. The key question is whether you want to control that speed. Right? You don't want to drop-- you know, when I say 50 percent down year on year, that doesn't sound like a soft landing. And that's not what you want, even if you think that the end game is fewer apartments being built. 5 percent year-over-year decline, you can run that over the next few years and sort of deflate a potential bubble rather than just burst it and that would have implications on local government financing. Because in China, a lot of local governments rely on land sales for revenue. That has an implication for consumption, confidence, upstream sectors, all the steel, and cement production. So, the repercussions can be quite significant given the degree of the decline we have been seeing.

Allison Nathan: In past episodes of weaker growth, we've also seen Chinese policymakers letting the currency depreciate to help offset that growth weakness. What's your view on this more broadly?

Hui Shan: Yeah. Interesting you mention that. And CNY has, over the past few sessions turned from an outperformer and very resilient currency to a sharply weakening currency. Right after the Russian invasion of Ukraine, we saw other EM currencies depreciating. But CNY was pretty resilient. But the past few days, CNY has depreciated versus the dollar, depreciating from 630 to almost 660. So, quite a big move by Chinese standards. What is really going on?

I think the Central Bank is a bit conflicted. On the one hand, the Chinese economy is facing downward pressure at a time the Fed is hiking interest rates. So, when you think about capital outflows of potential currency volatility, they sort of decided not to cut interest rates at this moment and not to even further exacerbate that interest rate differential movements. And also, we have commodity prices and inflationary pressures. So, they decided not to cut interest rates.

But at the same time, they seem to be okay to let the currency weaken a bit through their daily fixing. We're seeing that they're basically telling the market that some

depreciation is okay. I think that makes some sense that when your economy is under pressure you want to depreciate your currency, in a low-profile way. You don't want to be so high profile, cut your interest rate and potentially cause foreign investors to reduce their positions in the CNY currency. At the same time, if the currency themselves is deprecating, that helps your exporters. That helps your growth on the margin. So, that might be something that's happening.

But you know, given the style of Chinese policymakers, I would be very surprised to see they continue to allow this significant depreciation to happen, particularly when, you know, in history when we saw the currency movements. Once [UNINTEL] expectation is formed, it's very hard to turn it back. So, I would imagine the PBOC through their daily fixing expresses some concern over the extent of depreciation that we have been seeing.

Allison Nathan: Kinger, let's bring you into the conversation. The CNY is not the only asset that's been under pressure. We've seen substantial pressure across many Chinese assets given the risks that Hui and I have

been talking about. Are these risks more or less priced in at this point? If you look, for example, at the equity market? Or do you think there's more downside from here?

Kinger Lau: Sure, Allison. And I think clearly, we are going through a rough patch for Chinese equities. The market is down about 20 percent so far this year. And to a certain extent, as you said earlier Allison, I think we are in a perfect storm situation where we have a number of economic and regulation headwinds all going against the market at the same time.

Hui just talked about the COVID outbreak, and the property market downturn. But on top of that, we also have Chinese ADRs delisting risks from the US and the spillover of geopolitical risk from Russia to China. Chinese ADRs are essentially Chinese companies that are set up overseas and are currently traded in the US market. And one of the pretty significant concerns among investors over the past two years has been the potential delisting risks for these companies, especially after the Holding Foreign Companies Accountable Act has been written into law at the end of 2020.

US/China tensions have certainly intensified over the past two years. And it started with the trade war between the two nations. But later on, expanded into other strategic domains, including capital markets, i.e., the potential delisting of Chinese ADRs in the US market. And I think all of these risk factors have contributed to the quite weak performance of Chinese equities over the past two months.

That being said, everything has a price. And I think equity investing is all about assessing risk and reward. And at the moment, Chinese equities are trading below ten times the forward price to earnings price to earnings ratio, which is roughly speaking one standard deviation below the historical average. And from that perspective, we would argue that a good portion of these concerns and risks are already well discounted in [UNINTEL] equity valuations. And in fact, we would argue that China's still trading below our expected fair value. And there could be potential for recovery for valuation down the road as long as a global recession could be avoided and some of these risks do not develop into bigger systemic problems.

Allison Nathan: The broader issue that you mention, Kinger, of course, is that the Chinese government has been cracking down on certain sectors. This regulatory crackdown that we've been talking about for quite some time now, really since last year. And it stepped up when the government started targeting Chinese tech leaders.

So, if you think broadly, as the government tries to flex its might in so many ways, the overarching question that investors have been grappling with is, ultimately, are Chinese assets still investable given these risks?

Kinger Lau: Well, Allison, I think this is a fair question to ask. And our answer here is, yes, Chinese is still investable, at least from a regulation perspective for a few key reasons. First, Chinese regulators have repeatedly emphasized that the very heavy-handed regulation crackdown, like the one we had for the Chinese education sector last year, is unlike to repeat. And if that's the case, we think that the worst is likely behind us in terms of the regulation shocks to the equity market.

And the second reason is that we actually compiled a proprietary regulation tracker which shows that the regulatory tightening intensity level already peaked in late 2021. And since then, the intensity has moderated quite meaningfully over the past few months.

And last but not least, I would also argue that we think we're naturally transitioning from an enouncement phase of the regulation cycle to an implementation stage where we'll likely get more clarity and transparency of the regulatory measures. And I think investors should be in a better position to price these regulation impacts on earnings, as well as on valuations.

I think, ultimately, to state the obvious, the market doesn't like uncertainty. But I think we're getting more transparency about regulations. And hence, I still think that China is still very much investable from that perspective.

Allison Nathan: Hui, can you give us a little bit more detail in terms of the political transition or lack of transition, I should say, that might be happening this year?

And how that could inform what we are seeing from an economic policy perspective and markets perspective?

Hui Shan: Yeah. A couple of things. This is quite unusual. Because if you recall, President Xi's predecessor was Jiang Zemin. He was a leader for ten years and then Jintao for ten years. And then now President Xi is about to get his third term at the 20th Party Congress in October/November timeframe. And what that means for the economy, for the financial markets, a lot of indications. I'll give you a couple of examples.

One is when we think about infrastructure buildings, these infrastructure buildings tend to be lucrative for the contractors and local officials, who previously have been accused of corruption related to these projects. So, we're seeing more anti-corruption investigations going into this year. And we suspect that local government officials will be a bit reluctant to engage in a lot of infrastructure building [UNINTEL] for fear of being accused of corruption and potentially sort of not being promoted in these political transition years. That's just one example of how that could impact the economy.

On the financial side as well, I think these political calendars or big events, carry significance in China. If you think about last year, all the regulations and all the announcements seemed to happen after July 1st. The CCP's 100th anniversary. So, we kind of feel that policies are being frontloaded this year so that ahead of the 20th Party Congress, perhaps the third quarter GDP would look decent. But after that, perhaps, the growth may slow a bit because you've already spent all the money you allocated for this year due to front-loading and getting a good third quarter. So, those are certain examples of how this could impact the economy and the financial market.

And certainly, behind the scenes, I think who's going to be the number two, number three, number four, and so on on the [UNINTEL] standing committee that could have some political implications. But at least on the economic and financial side, we can see pretty concrete signs that this is going to be pretty important.

Allison Nathan: Kinger, what's your thought as we look to this 20th National Party Congress where Xi is expected to take on an unprecedented third term?

Kinger Lau: Well, I think if we look at this political event in a standalone manner, empirically, the equity market actually tends to perform quite well in the runup to the National Party Congress which happens every five years. And I think this historical pattern reflects market expectations that policy accommodations will be provided by policy makers to ensure some sort of economic stability ahead of the transition.

And I would say a top-down perspective is one of the key underpinnings of our relatively constructive views on Chinese equities over the next six to 12 months. Now, more specifically, I think from a longer-term policy direction standpoint, I think it's always important for investors to align their portfolio with policy directions when it comes to investing in China. I guess it's true everywhere, but I guess it's more so for China given how influential policy is to companies' fundamentals.

And based on that logic, President Xi is going to extend his power over the next five to ten years. I think some of his policy directions will also be quite important when it comes to investing in Chinese equities. And here we believe that sectors such as semiconductors, electric vehicles, green energy, and industrial technology will continue to receive policy tailwinds. And I think these sectors will be in a better position to deliver sustainable returns to equity investors.

Allison Nathan: And one area that we didn't touch on, but I think makes sense to in light of this big political year, in particular, is, of course, US/China trade tensions which had been a huge focus during the Trump era. Has lost a little bit of focus in the recent period in part because of the Russian invasion of Ukraine, which has really shifted the geopolitical focus to that area. But if you look at this big political event this year in China and the relationship between the US and China going forward, Hui, what are you focused on in terms of thinking about the trade relationship, where it's headed, and what it means for the economy?

Hui Shan: Yeah, I think the reality of a trade relationship is that China's such a big part of the global supply chain and a significant share of the global trade market. It's very hard to completely shut China off. You know, this is just from a reality check perspective. It's hard to see a complete decoupling, at least not in the foreseeable future.

But the other part of the reality is that Russia's invasion of Ukraine is just on top of what already happened that accelerated the decoupling, accelerated the security thinking and resilience of a supply chain, all of these things, you know, starting with US/China trade war. We saw companies contemplating should we diversify our supply chain? Some did. Some didn't. And then you had COVID. And especially when people see the very stringent rules for the Chinese government to implement the Zero COVID Policy when the rest of the world is reopening. That's another consideration of how the supply chain is going to rearrange itself and the trade flows between countries. And then you had the Russia-Ukraine war.

So, I think that the broader trend of not only trade as for control technology on the financial market, which King

can speak further to, and on the just views of how COVID should be dealt with, I think many dimensions, you know, the two countries are sort of moving apart from each other. That hasn't implications if you think about the Chinese emphasis on security. There could be food supply security. Energy supply security. Technology security. Data security. A lot of the things, initiatives, and policies Chinese policymakers are pursuing are in this broader context that we are in this new geopolitical environment that we need to have bottom-line thinking and make sure that we check the boxes when it comes to security. So, I think it goes way beyond the trade relationship and is kind of a broader trend that the two biggest economies in the world are marching towards.

Allison Nathan: So, if we look at all the headwinds you've discussed: lockdowns, property sectors, geopolitical tensions, regulatory crackdown, big political transition, what is your outlook medium-term, Hui, for the economy in terms of growth?

Hui Shan: Yeah, I think we have a view that previously you might think Chinese potential growth, 5 - 6 percent.

But we think we might be settling into slower growth. Because you are trying to solve the housing access problem, because you're trying to solve your energy security problem or your regulatory objectives, when you're trying to achieve some other goals, there will be costs. And the costs to us will be slower economic growth. So, we do think over the next few years, even if all of these initiatives and policy objectives are being achieved in a rather smooth fashion, perhaps the Chinese economic growth will only average between 4 to 5 percent growth rather than the previous 5 to 6 percent.

Allison Nathan: And Kinger, any last words then for investors as they buy China here?

Kinger Lau: Well, I think given what we've just discussed on the risks and concerns, I think we're definitely in a situation where these factors have inevitably complicated the near-term market outlook for some investments. But I would say the last key message from me would be that if we take a step back, I think the strategic investment case for Chinese equities remains intact, i.e., it's still the second largest and most liquid equity market in the world. The

capital market is still developing, and Chinese equities are still under-owned by foreign investors. We talk about less than 5 percent of fortune ownership in the onshore equity market. And I still think that is the place for investors to look for structural growth opportunities on a global basis.

Now, of course, Hui said that the longer-term potential growth may come down a little bit. But 4 to 5 percent is still not a bad number in a global context. So, my last message here [UNINTEL] is to really focus on policy beneficiaries and stay invested.

Allison Nathan: Kinger, Hui, so glad to have you both on.

Kinger Lau: Thank you.

Hui Shan: Good talking to you.

Allison Nathan: Thanks so much for joining us this Monday, April 25th, 2022, for another episode of Exchanges at Goldman Sachs.

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