

# FOCAL POINT

## China: Resilient amid global banking woes?

Authors: Vladimir Oleinikov, Christoph Siepmann, Guillaume Tresca

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Our Focal Point series explores topical issues on macro, markets and investment

- Given the recent banking turmoil and its likely negative repercussions on lending standards and growth in developed markets (DM), China might appear rather resilient.
- China is shielded from major crisis contagion by the fact that its post-Covid recovery will be predominantly driven by domestic factors and a mildly supportive economic policy. The banking sector still looks relatively decoupled from DMs. By contrast, the trade channel could turn out being weaker than previously envisaged.
- However, China has its own financial vulnerabilities, especially regarding the real estate sector. Moreover, geopolitical tensions and China's positions in the Ukraine war (possible weapon provision to Russia) and towards Taiwan could elicit a higher policy uncertainty and risk premium.
- Notwithstanding these risks, Chinese equities should benefit from attractive valuations (both in absolute and relative terms), higher earnings growth, a reaccelerating credit impulse, and moderate inflation. While retaining an overall underweight position on global equities, we keep our positive stance on China, suggesting an OW position.
- Chinese fixed income has benefited neither from the rise of risk aversion nor the reopening narrative. The negative carry makes sovereign local bonds unattractive, mainly explaining the large foreign outflows. Negative carry, poor FX prospects, and geopolitical risks will further dent foreign appetite.

The recent banking turmoil has temporarily rattled financial markets. While governments and central banks were quick to signal support, the jury is still out on whether many central banks' (CB) massive key rate hikes have led to only idiosyncratic or also underlying systemic risks. As described in a recent [Market Commentary](#) "the systemic component of the crisis lies in a large amount of unrealised losses across financial institutions – not just banks – which creates an inherent fragility, especially in the case of suddenly rising liquidity needs." Fears of a "repeat" of the Great Financial Crisis have dented confidence and led to eying not only the financial sector but also (commercial) real estate. At least, we

expect a tightening in lending standards which, together with elevated CB rates, will weigh on growth. We expect the US going into recession from Q3 on, and US as well as euro area growth rates between meagre 0.2% and 0.7% in 2023 and 2024. In stark contrast, China market reaction has been limited and Chinese economy looks shielded from major contagion.

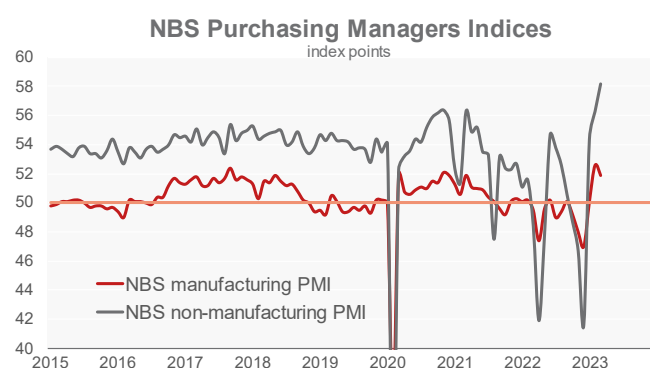
In the first section, we will present the main differences that provide some resilience to the Chinese economy. Then, we will show that the Chinese financial sector is relatively decoupled but has its own fragilities. Finally, we will present our equity and fixed income views.



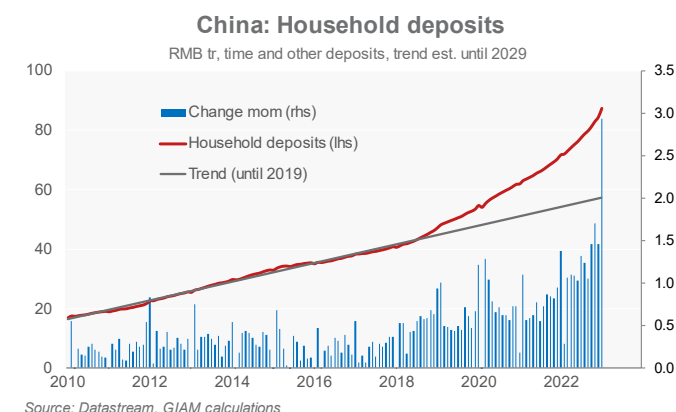
## China's economy to rebound, led by consumption

China looks shielded from major contagion by two principal differences:

- First, its post-Covid recovery will be predominantly driven by domestic factors and a mildly supportive economic policy. However, the trade channel could turn out being weaker than previously envisaged while China's real estate sector looks still problematic but is likely to stabilise.
- Second, the banking sector looks relatively decoupled from DMs, so that contagion could remain rather limited.



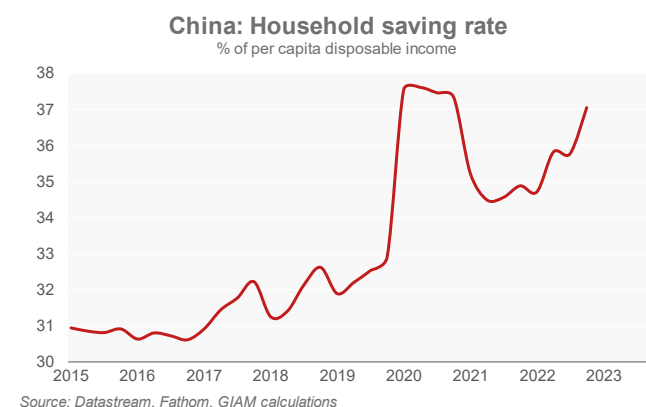
Indeed, after China's GDP had advanced by only 3% last year due to multiple Covid-related lockdowns, the Covid policy U-turn has made a recovery possible. The rebound has been so far most visible in the PMIs (see graph above) where the service sector even outpaced manufacturing. Some hard data, especially industrial production, was still a little soft in the first two months of 2023, but retail sales were in line with market expectations, investment surprised on the upside, while the housing contraction was narrowing markedly.



Unlike previous post-Covid periods, we expect private consumption, especially services (catering) to lead the rebound. The consumption upturn should be supported by the reduction of excess savings which accrued over the Covid

years. They are estimated between about 5% to 10% of GDP (5% equals RMB 5tn /US\$ 740bn), depending on different ways of estimates:

First, there is a strong rise in households' savings deposits above trend. However, some caution is advised about their excess size, as this rise is not only Covid-induced but also caused by the past collapse in home sales, weaker growth in wealth management products, and more precautionary savings (given China's limited health coverage). Second, based on national accounting, the savings rate can be calculated as the difference between national disposable income and expenditure (as % of disposable income, data are nationwide, per capita, cumulative). Applying some care, the data justify at least the expectation of a reduction in savings of about 2% of GDP (like in 2021, see graph). As some brokers calculated, household wealth declined in 2022, again demanding not to be carried away by excess savings.



We see the rebound to be less driven by investment. Infrastructure investment had been an important driver of growth last year but decelerated of late to a still high 9% yoy. We expect this type of investment to remain on a high level and benefit from a redirection of public expenditures from Covid-related spending to growth-supportive measures. Nevertheless, overall fiscal official policy (as announced at the National People's Congress (NPC)) is only slightly more expansionary than last year. While the 2023 growth target was set conservatively at "around 5%", the official general government budget deficit (3.0% of GDP vs. 2.8% in 2022), as well as the broad deficit (at 7.5% of GDP), will widen only very limitedly. Special local government bond issuance (RMB 3.8 tr) remained below expectations. These announcements suggest the fiscal impulse is set to shrink to almost naught and thus infrastructure investment growth (not level) to soften. Meanwhile, the drop in real estate investment and housing sales have narrowed substantially, 1/ given the government support measures on completing stalled projects, 2 /the seemingly soft interpretation of the "three red lines" approach, 3/ government financing help for developers, and 4/ the easing of home purchases restrictions at least in big cities.



We expect the contribution from housing to growth to turn from a big drag in 2022 to about zero or a small plus in 2023.

The NPC also described monetary policy as prudent (as always) but also as targeted (new), suggesting no broad-based measures. However, the PBoC unexpectedly cut the RRR by 25bp on March 17, freeing about RMB 530 bn, after a MLF liquidity injection only days before. We see another RRR cut in Q2. Strong credit growth (Total Social Financing) in the first two months of this year already induced a turnaround in the monetary impulse and we expect the rise to continue. The PBoC will likely not be very much restricted by inflation. Core inflation dropped in Feb. to 0.6% and headline inflation to 1%yoy. However, experiences from other countries typically suggest that a consumption-driven rebound comes with higher inflation. We expect this impact in China to be more limited as the country did not support households with additional transfers. Moreover, the labour market has spare capacity and exports have been shrinking, given China's recovery is running into softening global goods demand. All in all, we expect China's CPI inflation to rise over the next quarters and hit about 3% towards the end of the year, but to average 2.4% over 2023. We see GDP growth at 5.4% with Q2 being especially strong, given the reopening and a strong base effect.



## China's financial sector relatively decoupled

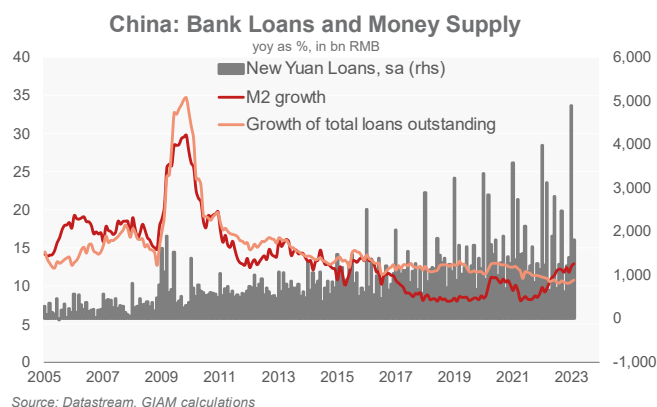
China's financial sector looks not very much prone to contagion. Fundamentally, China's monetary policy is not synchronised with Western countries. As China eased its monetary policy, the feared repercussions of Western CB tightening do not apply to China.

Regarding international contagion, China's banking system is relatively decoupled from DMs by existing capital controls, relatively modest cross-border lending exposures, "and the availability of liquid assets. Moreover, the banking system is de facto state-dominated and the PBoC was willing in the past to act decisively. China also seemed to be less affected in the

recent global bank sell-off (like other Asian countries). Cross-border bank exposures are also at manageable levels. Total cross-border lending runs around 5% of China-owned banks' balance sheets.

We also internally calibrated models<sup>1</sup> to build a scenario with banking stress and credit condition tightening equal to 50% of what happened in 2007/8. The main impact would materialise in 2024/25. But while the US GDP in 2024 could probably suffer by 0.8 pp and the euro area by 0.3 pp compared to baseline, China's growth might be negatively affected only by 0.13 pp, inflation by 0.08 pp while real exports of goods and services could diminish by about 0.64 pp.

This is not to say that China does not have its own financial vulnerabilities. According to [BIS data](#), total credit to the non-financial sector has risen strongly over the last year and now amounts to 295.9% of GDP. In addition, unclear risks are still buried in the real estate sector. Although developers got financial support, the debt consolidation of the sector looks merely postponed than solved. Real estate is also considered the sector with the most international links, as not only "Evergrande" made clear to international investors.



## China's equities: favourable outlook but risks remain

News of China's reopening and support for the battered RE sector in November 2022 was quite welcomed by the market participants. As a result, the MSCI China has rallied, outperforming other markets till the end of January 2023 quite significantly (ca. +50% vs 5% for S&P 500 and 15% for MSCI EMU). Thereafter, foreign investors started scaling back their purchases of Chinese stocks (-14% since the end of Jan.) due to persistent political tensions between US and China, still lingering uncertainty in the RE sector, and disappointment coming from the NPC meeting setting the real GDP growth at 5% (whereas the market expected at least 5.5%)

<sup>1</sup> We thank our colleague Paolo Zanghieri



#### major valuation measures

Stock index	PE	PE discount / premium	Avg market multiples* discount	PEG adj.	PE rel. to MSCI China Z-score	Shiller PE discount
S&P 500	17.9	13.7	20.8	2.2	1.2	10.6
MSCI EMU	12.4	-12.7	-0.5	1.6	0.3	1.5
MSCI China	10.6	-17.7	-15.7	1.4	-	-38.4
MSCI EM	11.9	-16.5	-11.9	2.0	1.2	-36.4

Note: market multiples include PE, PB, PCF, and DY. PEG is PE divided by expected long-term earnings growth.

PEG adj. (higher = expensive): PEG is modified by the ratio COE/ROE, which signals the ability to produce a return on capital higher than the cost of it. COE = cost of equity = 10yr gov't bond rate + 6% mkt risk premium x country Beta versus MSCI World (over the last 10 yrs). Discount in % to historical average: blue and neg. numbers = undervaluation.

Red and positive numbers = overvaluation. Shiller PE = index price divided by earnings averaged over a 10-year period adjusted for inflation.

Source: Thomson Reuters Datastream, IBES estimates, GIAM

Despite the rally in Chinese equities (overall +35% since Nov. 2022), the MSCI China still looks rather attractive on different valuation measures both in absolute and in relative terms vs other stock markets. Judging by the value indicator, which takes into consideration its 12-month forward earnings and 10-year yields, the market is undervalued by almost 16%. Our machine-learning (ML) indicates some slight undervaluation vs the MSCI EM (z-score of -0.6). As far as its conventional PE (10x) is concerned, it is currently at a discount of 20% vs its historical average. By the same measure, China's stock market is quite undervalued vs other markets: average Z-score of -1.0 vs EA and EM and -0.4 vs the MSCI EMU. The market looks likewise attractive when we look at the PEG ratio, which incorporates long-term earnings growth (PEG = PE/earnings growth). We proceed to modify the PEG measure by the ratio COE/ROE, which signals the ability to produce a return on capital higher than the cost of it. The cost of equity (COE) is calculated as 10-year government bond rate + 6% market risk premium x country beta versus MSCI WORLD. The adjusted PEG is 1.24 for the MSCI China, whereas other markets look more expensive (ca. 1.75 for MSCI EMU and MSCI EM, and 2.1 for the SP&500).

MSCI China: Value indicator

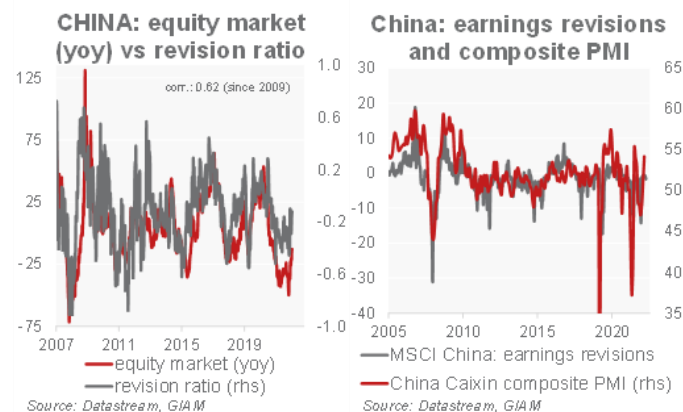


Source: Datastream, GIAM calculations

Chinese equities look likewise more attractive from an even longer-term perspective, which is captured by the Shiller or cyclically-adjusted PE (= index price divided by earnings averaged over 10 years adjusted for inflation). While China sells at a discount of 38%, the US has a premium of 10% and the MSCI EMU is essentially fairly valued (refer to the table above). In our country scores, which are derived from a composite valuation score (80%) and the average relative

performance over 6 and 12 months vs MSCI World (20%), Chinese equities have the most attractive rank.

As far as earnings expectations are concerned, the MSCI China's earnings revision ratio has been recently on the rise and would have further support from the dramatic increase in the composite PMI.



Source: Datastream, GIAM

Source: Datastream, GIAM

China's reopening with a rebound in domestic demand and economic activity would finally boost earnings. In this regard, it should be noticed that Chinese earnings are currently 10% below the trend since 2009, while those of the S&P 500 and MSCI EMU are 7% and 22% above the trend. The growth in the developed countries (in particular, the US and EA) is to suffer from banking sector woes, which are expected to last for longer and would feed through their economies amid tighter lending standards. We see a recession in Q3 2023 in the US, while the GDP growth in 2023 for the EA is forecast to be around 0.7%. This contrasts with the expected China GDP growth of 5.4%, an increasing credit impulse, and quite low inflation (headline at 1% in February with inflation expectations for 2023 at 2.4%). China's market is not without headwinds (see above) but we see some tentative signs of stabilisation in the RE sector (%mom home prices rebounding from cyclical lows), while economic momentum is increasing.

MSCI China and macro leading indicator



Source: Datastream, GIAM

MSCI China PE and credit impulse



Source: Datastream, GIAM

In sum, while retaining an overall underweight position on global equities, we keep our positive stance on China,



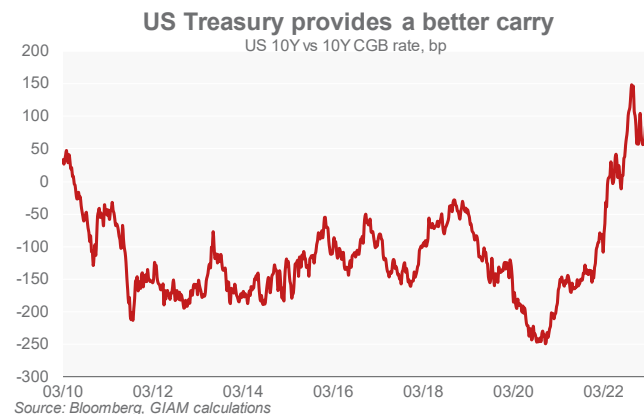
suggesting an OW position on the MSCI China index inside global equity portfolios.

On the risk side, geopolitical tensions and China's position in the Ukraine war could elicit a higher policy uncertainty and a risk premium (especially weapon provision to Russia).

### China Fixed income: poor carry limiting the foreign demand

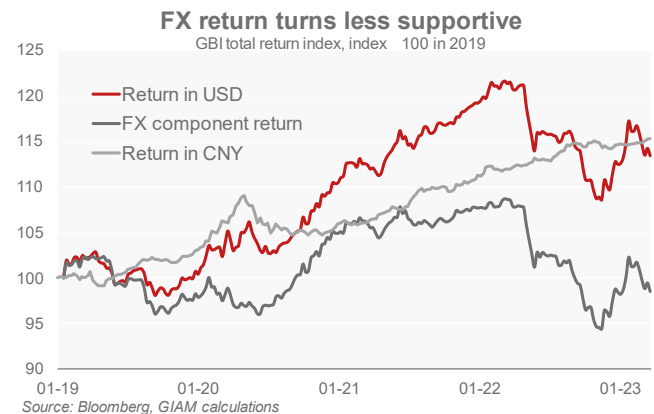
China's fixed income has experienced a mild performance over the past six months despite the announcement of the economic reopening. While it can offer a relevant decorrelation from other DM fixed-income assets historically, short-term factors and long-term structural concerns will likely limit the foreign appetite for Chinese fixed income despite the resilience of the Chinese economy.

Indeed, both external and local government bonds indexes have underperformed global bond indexes since early October. For instance, the Chinese external debt subindex underperformed by 4.5 percentage points the JP Morgan EMBIGD IG index, and spreads vs EM IG widened by 30bp. Likewise, local debt performance has been almost flat in local terms. The return has been essentially provided by the CNH appreciation vs the USD.



Globally, we continue to prefer EM local debt over EM external debt. China's local debt can benefit from a more resilient growth outlook and monetary easing. For instance, the surprising RRR cut on 17 March has provided support to the front end of the curve. In addition, we expect another RRR cut that will provide further support. That being said, DM bonds are also expected to provide a positive return this year. We still expect the 10Y US rate to reach 3.15% in twelve months. Accordingly, the share of foreigners in the CGB market has been gradually declining to currently reach 8.5% from an 11.1% peak in January 2022. Year-to-date flows are at -\$ 21bn, which is already 70% of outflows observed in 2022. Even during the positive period of the reopening and better real estate news flow, foreigner outflows have been significant.

There has been a low correlation between the periods of risk aversion/appetite and inflows. The CGB carry appears to be the main short-term factor rather than risk appetite. It will keep prevailing in the foreseeable future in our view. US 10Y Treasury currently provides its highest pickup over CGB on an unhedged basis since 2010, capping the risk/reward in investing in CGBs. Thus, even in a period of risk aversion where the Chinese economy would be resilient, we hardly expect renewed sustained inflows into the Chinese fixed income market.



Beyond these short-term drivers, structural changing forces have been at play. First, almost half of the CGB return for foreigners since 2019 has been provided by the CNY appreciation. Since mid-2022, there has been an inflection point. The rapid and significant CNY appreciation trend will structurally lose some steam in the years to come, depriving foreign investors of a significant return contribution. Second, since the war in Ukraine, geopolitical risks have gathered more investors' attention. The Taiwan-related tensions and the risk of sanctions could deter foreign investors in the long run. As a corollary, the ESG sovereign framework has further developed, gaining importance, especially in Europe. China can exhibit poor ESG metrics according to the ESG rating providers and thus preventing ESG investors from investing.





## Imprint

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<b>Head of Macro &amp; Market Research:</b>	<b>Dr. Thomas Hempell, CFA</b>
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