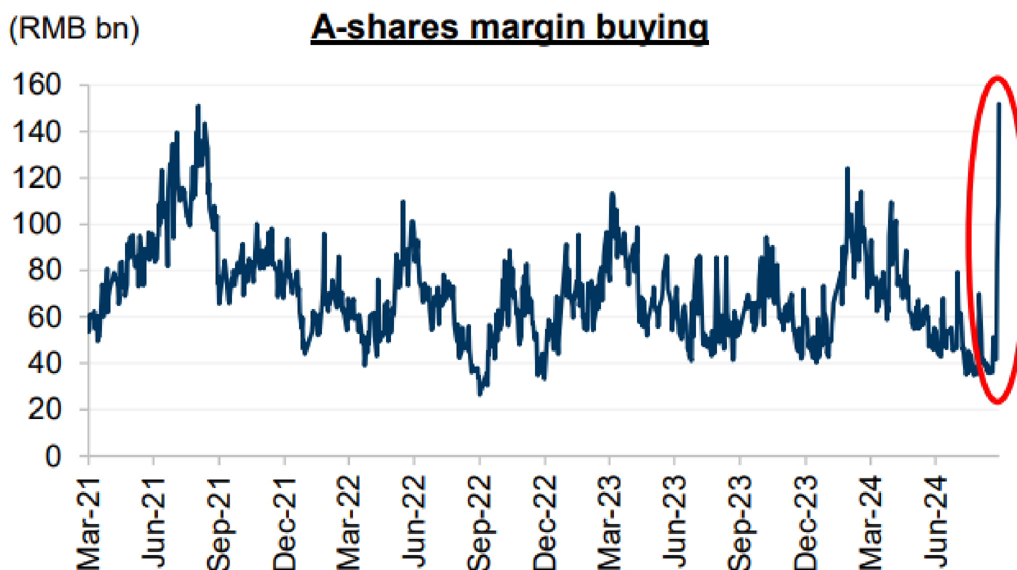
Thoughts from a China Bear – October 2024

Three years ago, we highlighted the long-term structural challenges facing China's economy: 1) Extended weak domestic consumption, 2) A declining population, 3) A deep freeze in the property market, and 4) The exodus of manufacturing supply chains and foreign companies. Two years ago, after China's chaotic COVID-19 reopening and continued sluggish demand, we concluded that this country was entering a prolonged period of "Balance Sheet Recession," similar to that experienced by Japan during the 1990s and 2000s. This foresight allowed us to steer away from the traps of "dead cat bounces" that occurred following the peak of China's markets in 2021. Currently, China is attempting to restore market confidence through significant monetary stimulus and ambiguous fiscal policies. The MSCI China Index rebounded from 40 on September 10th to 60 on October 7th, a 50% surge in just one month. Hong Kong's stock market's turnover increased to a daily average of HKD350 mn from an average of HKD100 mn year-to-date. A sharp rise in A-share margin purchases (see chart below) indicated an increase in participation from retail investors, while company insiders were attempting to offload shares. Does this sudden rebound in demand for Chinese equities suggest that China has already bottomed out? We don't believe so.

A-shares margin buying rose sharply above RMB 1.5tr, suggesting a continued pick-up in retail participation



Source: Wind, Goldman Sachs

The four key structural challenges facing China are unlikely to be resolved quickly or easily. Given the significant government intervention in the stock market and various industries, this rebound seems more like a trap set by the authorities than a long-term opportunity. These measures may create an illusion of stability, but they fail to address the fundamental issues that hinder sustainable growth. Firstly, China's property market, once valued at $65-75 trillion, has become perhaps the largest bubble in history. Experts estimate that this crisis is at least five times larger than the 2008 U.S. housing collapse, yet the rescue packages so far amount to less than one-fifth of the U.S. TARP and ARRA programs implemented in 2008. Secondly, the decline in the property market is affecting over 50 million jobs and has triggered a "reverse wealth effect" (where demand and consumption decline because investors feel poorer than they were earlier), meaning consumer confidence is unlikely to recover — especially given the current political climate, which favors socialism and an expanded role for state-owned enterprises (SOEs). Thirdly, while the demographic dividend has contributed to strong economic growth over the past 30 years, China's expired one-child policy is now the major factor contributing to the country's accelerating population decline, intensifying pressure on its economic outlook. Drawing from Japan's experience with a balance sheet recession, monetary stimulus alone cannot change pessimistic behavior, as businesses are reluctant to take on debt, increase leverage, and initiate new investments or CAPEX. The more promising solution would be fiscal stimulus. However, with China's total debt (household, corporate, and government) now about four times its GDP, it faces significant challenges in leveraging more debt for fiscal expansion.

Foreign companies are increasingly pulling out of China, affecting not only the manufacturing sector but also other industries that once capitalized on China's booming consumer market. This trend is evident in the sharp decline in U.S.-China travel. Even after COVID-19 travel restrictions were eased, U.S.-China flight activity remains far below pre-pandemic levels. During the first seven months of 2024, only 1.2 million travelers flew between the two countries, compared to 5.1 million in 2019. There were about 340 weekly flights between the U.S. and China pre-COVID, which is nearly four times more than the current number. European airlines such as Virgin Atlantic, British Airways, and Lufthansa have significantly reduced their services to China, discontinuing direct flights. Moreover, global businesses are also scaling back operations in China due to weak consumer demand and geopolitical tension. Recent victims of this rising tension have been U.S. corporate diligence firm Mintz Group and consulting firm Bain & Company, both of which have been targeted by Chinese authorities under the country's Counter-Espionage Law. Vanguard, the world's second largest asset manager, recently exited China completely, shutting down its Shanghai office and retreating from the country's $4 trillion mutual fund market. Luxury retailers like Coach and L'Occitane have either delisted from Chinese markets or sought secondary listings abroad. Meanwhile, manufacturers such as Samsonite and Foxconn are moving their supply chains to other Asian countries, and IBM closed its R&D operations in China, affecting more than 1,000 employees. Microsoft has relocated employees, and Citi Bank sold its consumer wealth portfolio to HSBC. Even world-famous restaurant Din Tai Fung is reducing its presence in China, closing 14 stores in the Beijing region as the economy loses steam, further reflecting the broader trend of foreign companies reconsidering their exposure to the Chinese market.

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