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China can Recover without Solving all of its Problems

SUMMARY

- Two months after COVID-zero policies ended, China's equity rally is taking a break. Many observers are focusing on the lack of progress in some facets of the Chinese economy as risks to the recovery.

- We believe that structural problems do not need to be resolved this year in order for the recovery to carry through. The potential for earnings growth and valuation repair can be realized without addressing every imbalance in China's economy and society.

- First, there is plenty of evidence of recovery. Lunar New Year tourism saw substantial growth from last year. Mobility indicators suggest urban traffic had already recovered to pre-pandemic levels. Domestic flights had also seen notable recovery, while international flights had just begun. Purchasing managers indices showed strong services recovery, while manufacturing has narrowed declines, though is still teetering at breakeven. Credit growth remained robust.

- There are also some areas of concern. Early mortgage repayments caught some attention, but are small in scale compared with precautionary savings accumulated in 2022. Property sales still lag, but are picking up after the COVID spread and the holiday. Unemployment remains high but is falling, which is a positive direction for markets. Geopolitical tensions will remain a thorny issue, but the recovery appears to be a bigger driver this year.

- Earnings revisions continue to move up, while valuation repair is lagging, even after the strong rally in Nov-Jan. Eight of 10 sectors have valuations below historical mean. We believe investors are likely to position for the next phase of recovery during the current setback.

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As China's economy makes progress, many concerns arose, but are unlikely to stop the recovery

China's recovery appears to be well on track. But markets have little patience, as many of China's problems are still unresolved, such as weak property sales, early mortgage repayments, unemployment, geopolitical tensions, Fed policy and the USD, or whether the excess deposits from last year were real. While these concerns present legitimate risks to the outlook, we believe a cyclical recovery does not require all structural problems to be resolved.

After a 60% rally from November to January, the MSCI China index consolidated by 7% in February. This seems to be very typical of any bull market. When the initial short covering phase is done, the market takes a break. Upward earnings revisions continue, while valuations remain low, which are likely to bring broader participation for the next phase.

In this note, we lay out the evidence for recovery and try to address some of the market concerns. The recent setback in markets may present the opportunity to get on the train.

Evidence of China's recovery

Holiday consumption, mobility, manufacturing and services activity, and property have all shown evidence of recovery

- Lunar New Year holiday domestic travellers increased 23%y/y. Domestic tourism revenue rose 30%y/y, and returned to 73% of 2019 levels. Post-Lunar New Year mobility data also continued to improve, including urban road traffic and subway ridership, which are now 13% above 2019 levels (**Figure 1**). Domestic air passenger traffic is 25% above a year ago. But since international travel has yet to rebound, total flight traffic is still 3% below year-ago and 19% below 2019 levels.

- Services PMIs rebounded sharply in January to 54.4 and 52.9 for the official and Caixin surveys, respectively. Manufacturing PMIs were less in unison, with the offical survey rebounding from 47.0 in Dec to 50.1 in Jan. The Caixin survey was remarkably flat at 49.0 to 49.2 for Dec-Jan, somehow missing the volatility at the turn of the year. Compared to the other major economies, China's manufacturing PMI is now the highest after lagging badly in 2022 (**Figure 2**).

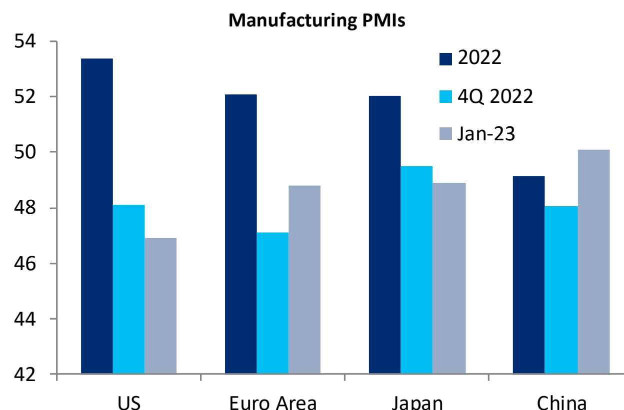
- Property sales are picking up strongly in February. Anecdotal data show that both new and existing home sales jumped in the first week of February in both top-tier and lower-tier cities, just after the Lunar New Year holiday. Land sales have also resumed, with nationwide sales rising 34% from the depressed levels of 2022, led by lower-tier cities (**Figure 3**). For example, the first land auction in the Year of the Rabbit in suburban Beijing sold six plots, half at ceiling prices (prices are capped by regulators and have floors defined by the selling local government).

Figure 1: Recovery Signals

	2023 Y/Y%	% of 2019 Levels
Lunar New Year Golden Week		
Domestic Tourists	23%	89%
Tourism Revenue	30%	73%
Macau Visitors	297%	57%
Macau Gross Gaming Revenue	83%	46%
Mobility in February		
Traffic Congestion	27%	N/A
Subway Ridership	63%	113%
Airline Passengers	-3%	81%

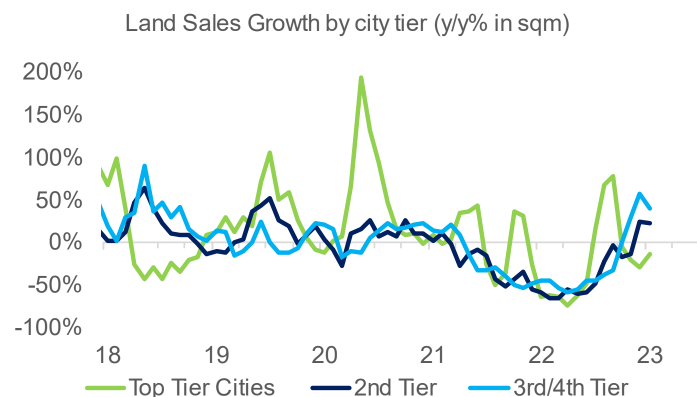
Source: Bloomberg, Haver Analytics, as of 10 Feb 2023.

Figure 2: China's manufacturing PMI is again in expansion, also the highest among major economies



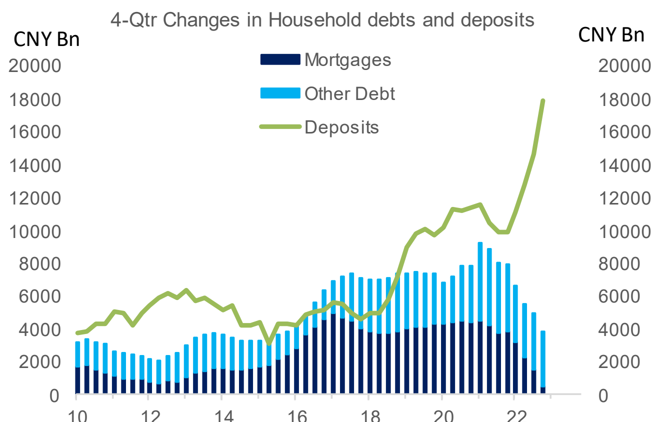
Source: Haver Analytics, as of Jan 2023.

Figure 3: Land sales turned to positive growth after depressed 2022



Source: CREIS, Citi Research, *China Property—Poised for Sales-Driven Rebound; Multiple Early Signals Flashing*, as of 8 Feb 2023.

Figure 4: The buildup in household deposits far outpaced additional debt in 2022



Source: Haver Analytics, as of Dec 2022.

Addressing Concerns

Are households making early mortgage repayments rather than spending?

Precautionary savings appear enough to consume and service debt

Yes.While debt servicing will take away from consumption, we believe Chinese households have set aside enough precautionary savings to do both.

A flurry of early mortgage repayments since the end of last year has created some concern recently that Chinese consumers may be more eager to pay down debt than to consume. But Chinese households had accumulated 18 trillion yuan in new deposits in 2022, a record 15% of GDP. This is equivalent to 46% of all outstanding mortgages.

Meanwhile, household debt increases were the smallest in a decade. The fear of unfinished projects was so intense that for all of 2022, home sales were down 28% to just 11.6 trillion, while only 480 billion of new mortgages were taken out to finance these humbled purchases (**Figure 4**). In other words, the loan-to-value ratio in 2022 was a paltry 4.1%.

Are those trillions of new deposits real?

Yes, they are. Some researchers point out that actual excess savings are not nearly as large, and those savings disproportionately belong to the wealthy.

Deposit surge reflects delayed spending and investment, which is fuel for recovery in both economy and markets

While these are correct observations, they confuse an income statement concept (savings) with cash flows (deposits). Savings account for income minus consumption, but does not capture outlays for investment into property and securities. In 2022 households did not make the usual property and stock/bond investments, which lifted deposits, while the lack of consumption would have lifted both savings and deposits. As a result, deposits are a better indicator of potential ammunition for consumption and investment in 2023.

The uneven distribution is a meaningful concern. Unlike the fiscal handouts that were common in the US and Europe, China's stimulus was done through infrastructure, bank credit and lockdown subsidies, while employment income actually weakened. This would suggest that a majority of the new deposits belong to high income households who would have lower propensity to consume. Still, this issue would unlikely have a major impact on markets, as the high income households have more investment capital.

Property sales are still weak, will that drag the recovery?

Property sales have shown some early signs of rebound after holiday

Unlikely, because property sales are poised to recover. In January, property sales remained tepid at -33%y/y at the largest developers. But this was a month of nationwide COVID infections followed by the Lunar New Year holiday. In the week after the holiday (Jan 30 – Feb 5), property sales rebounded sharply, according to local market data. Sales may still be short of year-ago levels, but the rebound was nationwide across high and low tier cities (**Figure 5**). And as noted previously, land sales have begun to rebound as well across the nation (**Figure 3**)

Perhaps the longer-term prospects remain poor for property development. But even with a 20% recovery this year, property sales would still be just at 2016 levels, which should not cause concern for overcapacity yet.

With job prospects still uncertain, will households spend their savings?

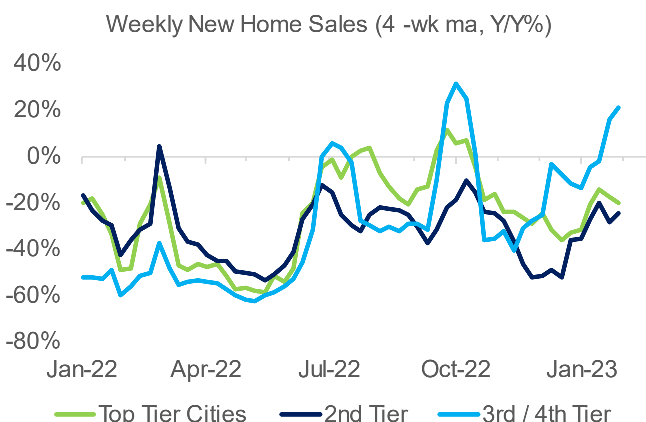
First, the revenge spending has already begun, and has more room to go. For example, Macau gaming revenue surged by 82.5%y/y in January, though still well below 2019 levels (**Figure 6**). Mainland visitors jumped by 150% during the holiday week. Traffic at restaurants, movie theaters and shopping malls have also surged. When retail data is reported for Jan-Feb together on March 15, it is likely to be notably positive.

Labor market friction is real. So are the recovery in labor demand and the fall in unemployment rate

As for jobs, some observed that youth unemployment remains high. Still others observed that the 30-plus segment of the labor force is facing problems, as employers prefer younger and cheaper applicants. This friction is driven mainly by the decline of job availability in the internet sector, such as platforms and online education. But these sectors are seeing fresh demand growth, just one month into the beginning of service sector recovery. Even at this early stage of recovery, the unemployment rate in both the youth and 30+ segments have fallen recently, just faster in the younger group (**Figure 7**).

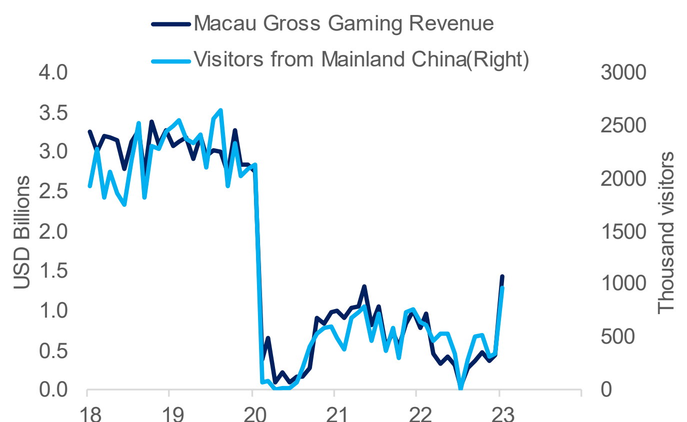
As we noted in the past, equity bull markets happen when unemployment is high and falling, rather than low and rising. Labor force friction is more likely to produce higher wages and inflation in areas of undercapacity, such as air travel and hospitality. This is something the central bank would need to worry about in time. But for now, the impact on markets is likely limited when overall demand for labor is on the rise. Even in the longer run, the aging demographic trend would likely ease labor force frictions, as the definition of "young" is likely to rise.

Figure 5: Property market activity recover in early February, right after Lunar New Year



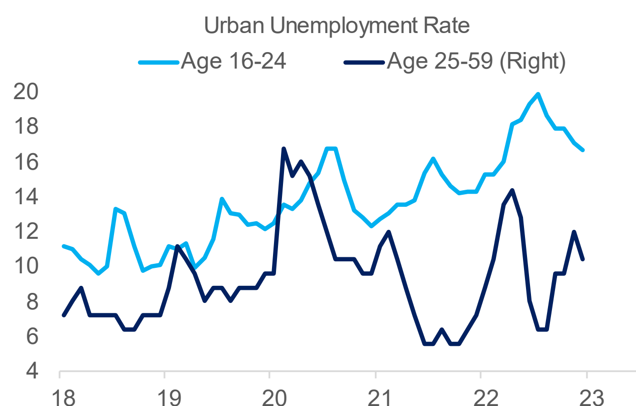
Source: CREIS, Citi Research, *China Property—Poised for Sales-Driven Rebound; Multiple Early Signals Flashing*, as of 8 Feb 2023.

Figure 6: Macau gaming revenues jumped by 83%y/y in January, as Mainland visitors surged 150%y/y during holiday week



Source: Haver, as of Nov 2022

Figure 7: Youth unemployment is coming down from high levels faster than overall labor market



Source: Citi Research forecasts, Global Economic Outlook & Strategy, Haver Analytics, as of 18 Jan 2023.

Figure 8: The rally in Chinese equities had 40% lower turnover compared to 2020-21 highs, reflecting low participation

Source: Haver, as of Nov 2022

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Missed the first rally? So did most others, and that's why there is likely a second leg

Rally so far has had low participation, the next phase is likely to see broader inflows

Still some precautionary deposits came out of the stock and bond markets last year. But the recent rally had 40% lower turnover, compared to the frenzy period of 3Q 2020, or the bubble peak of 1Q 2021, or the initial period of common prosperity in 3Q 2021 (**Figure 8**). This low participation is common in both offshore HK and onshore A-share markets, implying large numbers of Chinese investors still sitting on the sidelines with idle deposits to deploy among the things they held off in 2022.

Will inflation come back and end easy policy?

Yes, but not right away. China's inflation data remain weak. CPI rose just .1 %y/y in January, while core CPI remained at 1.0%y/y. Industrial deflation also continued in January, as PPI was -0.8%y/y. These still reflect the economically crushing COVID zero policies in 2022.

Monetary policy may turn more hawkish when inflation rebounds, but further equity rebound is likely to accompany the return of inflation

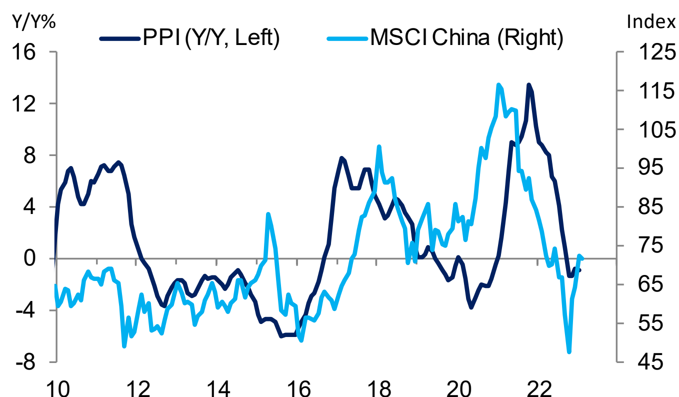
As demand rebounds, inflation is likely to rebound as well. It would take some time to get to levels that might warrant policy concern. In fact, there may be additional consumption supportive policies to be announced surrounding the national legislative meetings in March. We suspect that People's Bank of China (PBOC) may turn more neutral and pay more attention to inflation by the mid-year policy meetings in July. Potential rate hikes are possible by year-end if inflation rebounds sharply.

But most importantly, a level of inflation that might be consistent with policy tightening would also imply a much higher level for equities (**Figure 9**). As a result, we would expect another leg of equity rally before the PBOC turns hawkish.

USD is rebounding again. Will external risks drag China down?

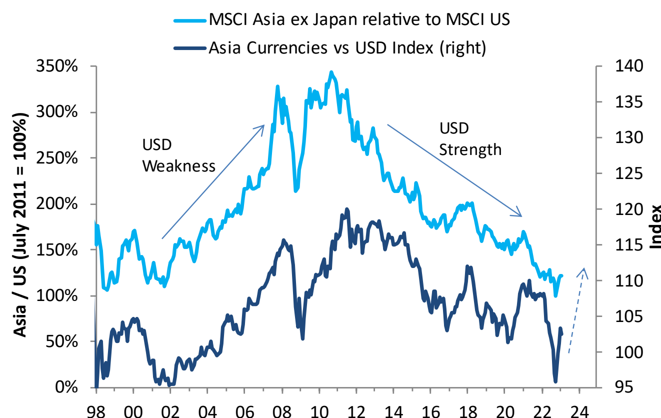
The recent bout of strong US labor and inflation data amid hawkish rhetoric from the Fed has set off a rebound in the USD. However, the US economy is also showing more signs of fatigue after the historically aggressive tightening campaign the Fed had already put in place. Manufacturing PMI new orders have fallen to a recessionary level of 42.5; banks are tightening lending standards consistent with the lead-up to recession. And the strength in jobs and retail sales may dissipate once seasonal factors become less dominant.

Figure 9: China's PPI remains in deflation but is likely to lift up along with economic and equity recovery



PPI is producer prices index. Source: Citi Research forecasts, Global Economic Outlook & Strategy, Haver Analytics, as of 18 Jan 2023.

Figure 10: USD bear markets have been positive for Asian relative equity performance



Source: Haver, as of Nov 2022

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USD bear market is likely to return along with weaker US growth, Asian equities may outperform

We expect China to potentially turn to unwind stimulus late this year. Incidentally, that is also when we expect the Fed to pivot to rate cuts. This will likely support Asian currencies and would be supportive of our positive view for equities in the region. The last USD bear market versus Asian currencies started in 2002 when Asia exited five years of deflation from the Asian Financial Crisis. This was a period of strong relative equity performance for Asia (**Figure 10** . Even though the current backdrop isn't as positive as that time when China just joined the WTO, it could still draw some parallels.

Will US-China tensions curb the extent of investor interest?

Yes, this is one of the main open ended concerns that is keeping many investors at bay.

ust as the balloon incident calms down, China's closer ties with Iran becomes another challenge to further talks between the world's two largest economies. The strategic competition between the two countries is likely to continue for many years to come. The US curbs on China's access to technology and to US investors, though not impenetrable, are likely to get tougher.

Geopolitical tensions may be less impactful during initial economic recovery

Still, we continue to believe that in 2023 geopolitical overtures are less likely to be impactful on markets because the potential for economic recovery is strong. Beyond initial recovery and after valuations return to a level consistent with economic expansion, however, the market may be more influenced by geopolitical tensions.

Earnings revised up more than valuations

Earnings revisions have continued in the direction we expected. In the three months through mid-February, consensus EPS estimates for 2023 had been revised up by 7%, which is nearly halfway to the 15% we estimated for the year (see CIO Bulletin: China's Reopening Rally, Part 2, 16 Jan 2023). Meanwhile, the forward PE ratio remains below historical mean at 10.8x. When revision momentum had been this strong in the past, the valuations were much more generous (**Figure 11**).

At a sector level, revisions have been uneven. Eight of 10 sectors remain below ten-year average valuations (**Figure 12**). The IT sector stands out, as the farthest below historical mean in terms of valuations, while its earnings revision momentum is also strong. The IT sector is likely to be a candidate for catch up in the next phase of recovery, as investors shift from companies that had the highest beta to those that have the best growth profile at reasonable valuations.

Earnings revisions are progressing faster than valuation repair

IT, Healthcare and Financials offer growth opportunities at reasonable valuations

The strongest revisions came in the Healthcare sector, and the sector is expected to grow the most in the coming two years. This helps to explain its higher valuations, which are at par with its 10-year average. Similar to IT, healthcare is likely to be among the targets for investors seeking growth in the next phase of recovery.

The Telecom services sector valuation comparisons are made difficult from adding internet content platforms to the sector that used to consist mainly of network operators. But here too earnings revisions are strong.

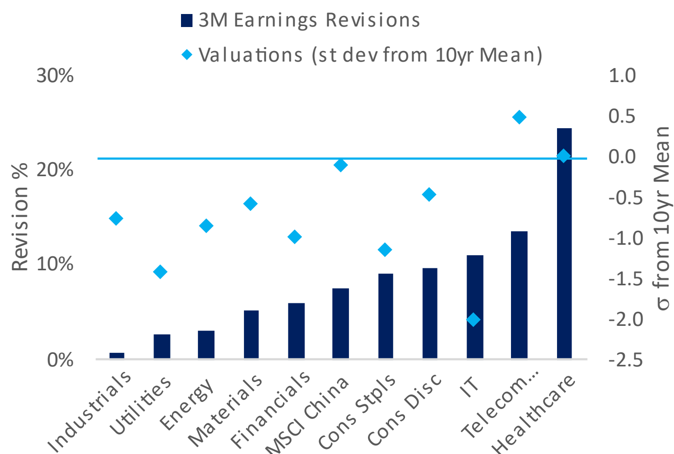
Financials may see continued upward revisions. Banks may see net interest margins improve along with steep yield curve and higher rate expectations, as well as less asset quality worries. Similarly, insurers are seeing fewer asset quality worries, as well as improving investment returns. Brokers and wealth managers may benefit from a revival in market activity.

Sectors like Materials, Energy and Industrials face more difficulties in earnings revisions, as their results were less challenged in 2021-22. These sectors may enjoy some cyclical demand pickup, but tend to have less robust long-term prospects.

Figure 11: Earnings revisions are progressing faster than valuations

Source: Bloomberg, as of 15 Feb 2023.

Figure 12: Eight of 10 sectors remain below historical mean valuations, while earnings revisions vary



Note: Valuations are measured as standard deviations (σ) from mean for the forward price/earnings ratio for each sector index.
Source: Bloomberg, as of 15 Feb 2023

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