

## China confronts contradictions

*Izak Odendaal, Investment Strategist at Old Mutual Wealth*

“A land of contrasts” is probably the most tired cliché in travel writing. It also happens to be true of most countries. When it comes to economic matters, there are few places in the world today where contrasts are as noticeable as in China.

To name but a few: exports to the US have plunged in the face of steep import tariffs, yet the overall Chinese export performance is stellar. China has among the lowest interest rates among major economies, but borrowing growth is stalling. Though officially a communist country, competition in some industries is fiercer than anywhere else. Even as it astounds the rest of us with its technological capabilities, sentiment among ordinary Chinese seems depressed. In contrast to that despondent mood, Chinese equities have put in one of the strongest performances in the world this year. Despite maintaining economic growth rates South Africa can only dream of, there is consensus that a new growth model is needed. Let’s tackle these apparent contradictions and the underlying themes that unite them.

Starting with trade, tensions recently resurfaced with Beijing announcing export restrictions on rare earth elements and US President Trump threatening massive new tariffs on China, before things calmed down. Negotiations are underway again and Trump and Chinese leader Xi Jinping are still scheduled for a face-to-face meeting in Korea this week. Stepping back from this to and from, two points stand out: both countries are trying to reduce dependence on one another and increase self-reliance. And it won’t happen overnight, if ever. Each country has pain points that the other can exploit, such as the fact that China is by far the biggest source of rare earths, which are low-cost but essential ingredients for electronics, planes and defence systems. China meanwhile needs US high-end semiconductors. Ultimately, an uneasy truce is likely where the two giants continue to trade but also keep looking for alternative sources of supply and demand.

**Chart 1: China export values**



**Source: LSEG Datastream**

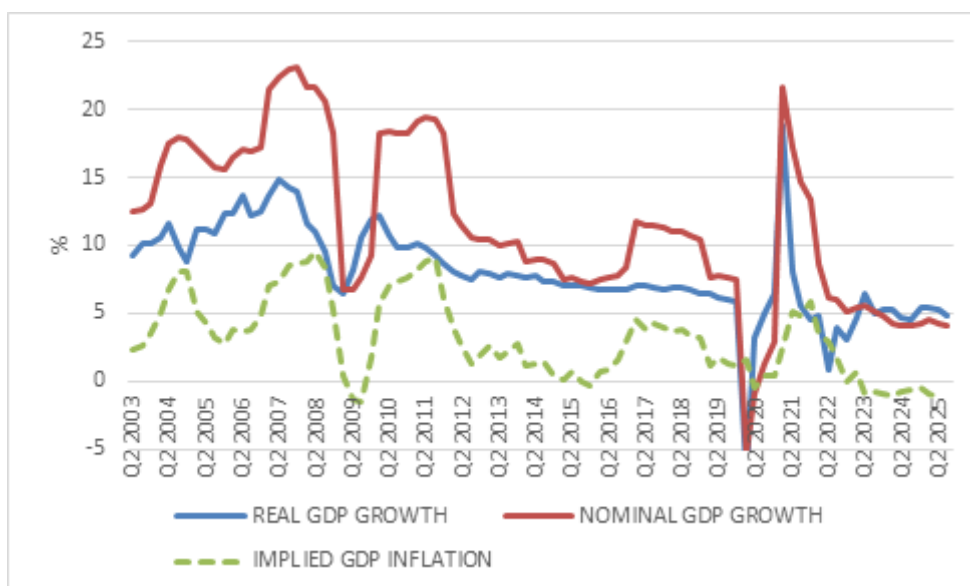
China is making strides in both fronts. On the demand side, its exports to other countries have more than offset lost sales to the US, though this is likely to include a fair degree of exports rerouted through other countries to avoid US tariffs.

The country continues to move up the technological ladder, including developing its own supply of homegrown semiconductors. Gone are the days of China only producing plastics, toys and textiles. Today it leads in drones, robots, solar panels and more. It became the biggest car exporter in the world in 2023, driven not by manufacturing on behalf of US, European and Japanese brands, but its own homegrown brands. Similarly, though Chinese factories still produce the iPhone on behalf of Apple, Chinese cell phone brands are growing in global reach. This is significant, since being an outsourced producer for a foreign company means basically only manufacturing jobs are created in China. On the other hand, Chinese brands like Huawei and Xiaomi employ many white-collar workers in design, engineering, marketing, finance, legal and more on top of factory jobs.

### *Involution*

Yet, despite these achievements – and they are truly impressive – one can have too much of a good thing. In many product lines, there are too many firms, leading to excess capacity and cut-throat competition. The government calls this problem “involution” and is looking for ways to address it. Ironically, the overzealous expansion of these firms is often due to government directives in the first place, usually driven by local or regional officials. The net result is razor-thin profit margins and price cuts to eke out sales. It means the wait for dividends and bonuses by shareholders and employees respectively is very long. Eventually, there must be consolidation, and Beijing is urging this, though it will include bankruptcies and lay-offs, making it a far from a painless process. Faced with domestic oversupply, these firms also have no alternative but to look for export markets.

**Chart 2: Economic growth in China**

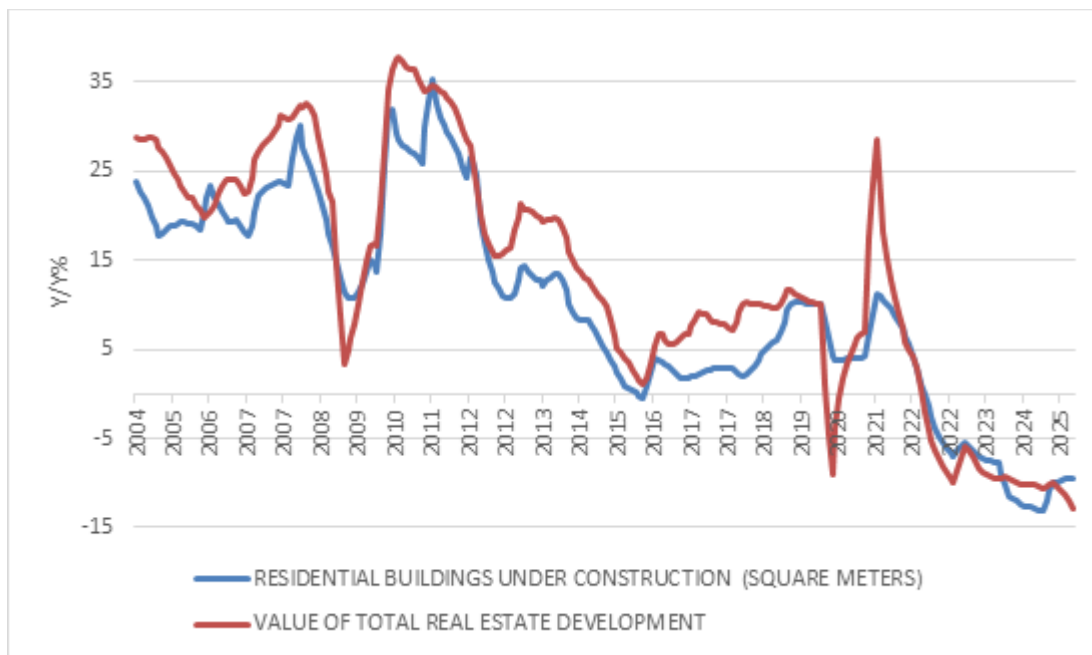


**Source: LSEG Datastream**

Despite these challenges, China’s real economic growth rate has held up well around 5%, though it is clearly lower than during the pre-Covid years. Look closely at chart 2,

however, and it will become apparent that it has been higher than the nominal growth since 2023. Nominal growth includes inflation and should therefore normally be higher than real growth. To use the analogy of a company, sales revenue growth is usually higher than volume growth. This implies the economy is experiencing deflation resulting from industrial overcapacity and soft household demand. Deflation also implies weak growth in incomes, company profits and tax revenues. This means it is particularly pernicious in an economy with high debt levels, as is the case in China. Those high debt levels also mean there is little appetite for new borrowing even though the People's Bank of China has cut interest rates.

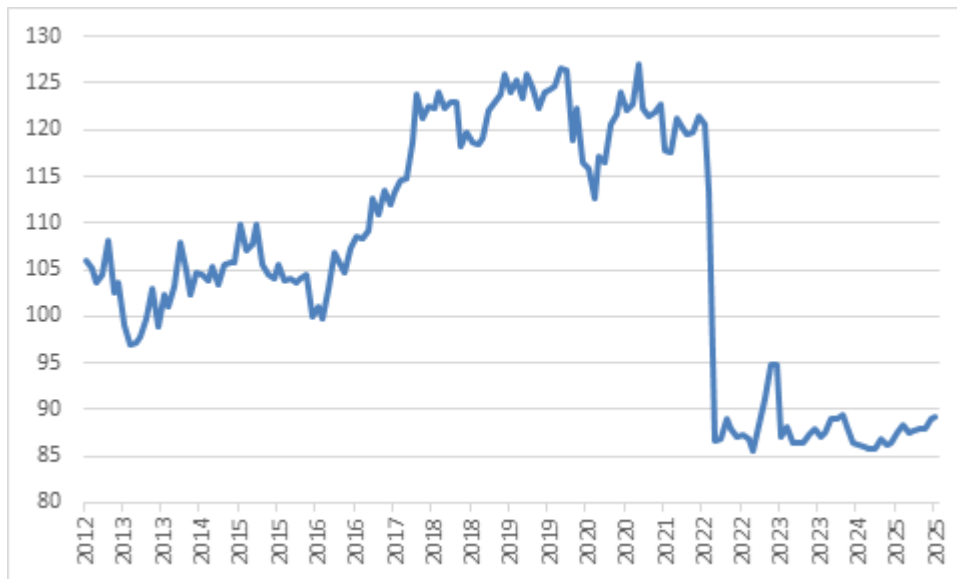
**Chart 3: China real estate development activity**



**Source: LSEG Datastream**

A big part of the story is the implosion of the property bubble that continues to reverberate throughout the Chinese economy. Real estate investment remains well below 2021 levels, when the government introduced the “three red lines” policy intended to curb excesses in the sector but triggered a collapse instead. The consequences have been profound. Not only was property development the major growth driver of the economy for many years, but property ownership was also the main store of wealth for Chinese households. Falling house prices have therefore weighed on consumer confidence. With a shrinking population, it is not a given that prices will ever fully recover.

**Chart 4: China’s consumer confidence index**



**Source: LSEG Datastream**

And as with any property bubble, a lot of debt was accumulated when it was blowing up, especially by developers (homebuyers typically made large down payments, limiting their gearing). Local governments also borrowed freely against land they would sell to developers, using the proceeds to build (and sometimes overbuild) infrastructure. Those debts still exist, often in off-balance sheet vehicles, but selling land can no longer be a large source of revenue. Many local governments therefore struggle to pay salaries and contractors and must scale back public services.

*New growth model needed*

The recent policy responses to these challenges have been, and are likely to remain, targeted and gradual, avoiding the “big bazooka” approach employed a decade and more ago. This includes gradual interest rate reductions and limited fiscal measures to support consumer spending and the housing market. The gradual approach is partly because debt levels are already high, while policymakers want to transition away from the real estate and investment-led growth model towards one that focuses on producing higher-value products, innovation and “common prosperity”.

The leadership of the Communist Party met last week to deliberate on the 15<sup>th</sup> five-year plan for 2026 to 2030. The details will only be announced next year, but the communique from the sessions still emphasises self-reliance, innovation and the need to “upgrade traditional industries as well as foster, strengthen and expand emerging and future industries.” This model essentially rests on productivity growth, leading to eventually more profitable firms, rising incomes and more tax revenues for the state. The latter will eventually allow for a larger social safety net which will be increasingly important as the population ages. It is no longer a growth-at-all-costs mindset, but one that focuses on “quality” growth – though the emphasis is on production and innovation and not on increased household consumption as many Western economists have long urged Beijing to target.

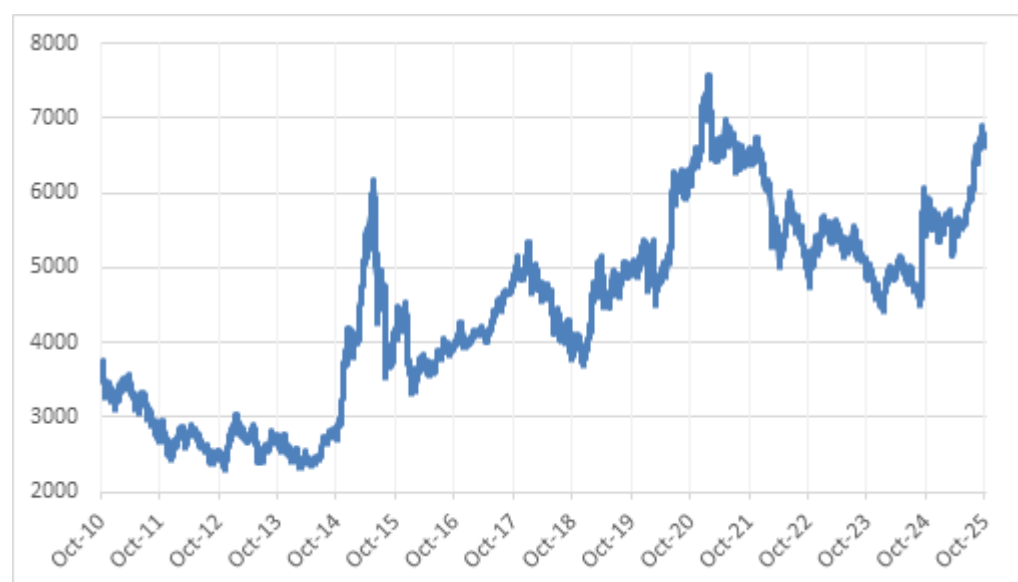
Policymakers outside of China will probably view the above with some alarm. Unlike countries like Japan, Korea and Taiwan that shed the low-value manufacturing as they climbed the technological ladder and grew richer, the communique confirms that Beijing wants to gain further ground in high-tech industries while maintaining its dominance in

lower value manufacturing through upgrading existing factories. With household consumption still relatively low, much of this production must be exported. This limits the chance for poorer countries to start the industrialisation process from the bottom. Therefore, while tensions with the US remain a near-term threat, perhaps the biggest longer-term risk to the new growth model is that the rest of the world follows America's lead in restricting Chinese imports. China's share of world exports has already increased from 4% to 14% in the past 25 years, making it the world's largest exporter. Can it rise further?

### *Slow bull*

Finally, there is the stock market, which had a strong year despite the challenges described above. However, Chinese shares have rarely had much connection with the economy and have in fact underperformed. Over the past 15 years, China's annual nominal GDP growth averaged an impressive 8.6%, while the onshore market as measured by the CSI 300 Index returned only 4.3% per year including dividends. Over the same period, the S&P 500 returned 14% per year.

**Chart 5: CSI300 Index including dividends**



**Source: LSEG Datastream**

The stock-market was basically seen as a sideshow by the serious people in Beijing and prone to speculative behaviour. With ample credit available in the banking sector, firms did not necessarily need the stock market to raise capital. However, policymakers appear to have had a change of heart on the role the equity market can play, as China analyst Dinny McMahon has argued. Firstly, to fund the sort of innovative companies the government wants to encourage, bank credit is not enough. Equity funding, both private and public, will need to be part of the mix. Secondly, in the wake of the burst property bubble and given the low-interest rate environment, households need an alternative wealth creation mechanism. Rising household wealth can in turn raise spending levels. Thirdly, equity markets can play an important role in China's underfunded pension system, especially given that low interest rates actuarially increase the long-term obligations of pension funds.

For these reasons, policymakers have recently taken steps to clean up governance at listed firms and brokerages and are trying to build trust in a market once widely derided as a casino, for instance by encouraging higher dividend payments and share buy-backs and increasing the role of long-term institutional investors such as insurance companies. As the state-owned Economic Daily newspaper noted, "it is necessary to take measures to increase market activity, and push stocks toward a 'slow bull' market." In other words, the kind of market where equity values rise over time as they do in the US or South Africa. Even though there are hiccups along the way, investors in these countries have enough trust in the market to put a sizeable portion of their savings into it.

Beijing has engineered rallies before and they've tended to fizzle out, most recently in September 2024. This appears to be a different approach. Instead of trying to push up share prices by pumping money into the market, it is about creating the conditions where share prices will naturally rise over time. If they get it right, there will be a feedback loop between companies raising capital and putting it to productive use, growing their profits and paying more taxes to the state and dividends to the shareholders, and rising share prices that will leave Chinese households better off – the way it works, or is supposed to work, elsewhere. This will not necessarily be easy and represents a bit of a chicken and egg situation. Sustained price gains will require a broader investor base that grows over time, but those potential investors also need to gain trust in the market, and the best way to do this is through steady price gains over time.

In summary, China has not resolved its economic contradictions, but it is trying to find a way through. It wasn't that long ago that China was considered uninvestable due to policies seen as unpredictable and unfriendly to shareholders. There will always be questions about policy certainty, but the uninvestable label is unhelpful for foreign investors, particularly those outside America that don't have the sense of direct geostrategic competition. The transformation of the world's oldest living civilisation continues and there will be challenges ahead. But there will also be opportunities for investors who can be comfortable with contrasts.