



NEWSLETTER

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CHINA DEBT

The debt-heavy property-driven growth model has become unsustainable and could end in crises.

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CHINA EXIT

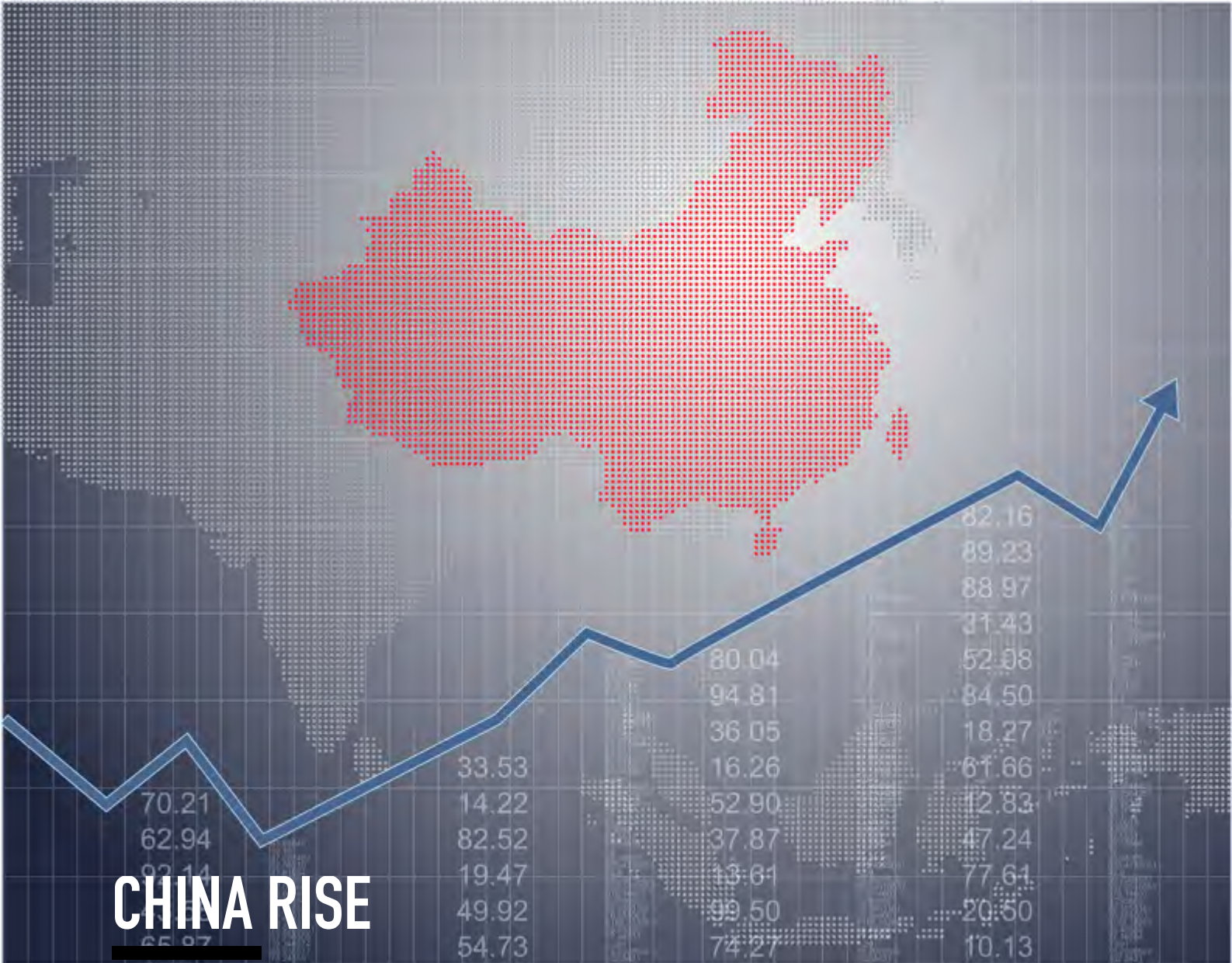
The benchmark emerging markets index is down -5% over 3 years, but if you exclude China, the index is up 20%¹. Is it time to exit China?

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CHINA TECH

China is bidding for global leadership in technology. Could tech reshape its economy and enable it to scale new heights?

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CHINA RISE

“THE CHINESE ECONOMY IS NOT A POND, BUT AN OCEAN. THE OCEAN MAY HAVE ITS CALM DAYS, BUT BIG WINDS AND STORMS ARE ONLY TO BE EXPECTED. WITHOUT THEM, THE OCEAN WOULDN’T BE WHAT IT IS. BIG WINDS AND STORMS MAY UPSET A POND, BUT NEVER AN OCEAN.

WHEN YOU TALK ABOUT THE FUTURE OF THE CHINESE ECONOMY, YOU HAVE EVERY REASON TO BE CONFIDENT.”

PRESIDENT XI JINPING

The marriage of capitalism and communism took place inside the Astor House Hotel, the first Western hotel in Shanghai and its most luxurious prior to the creation of the People’s Republic of China. In 1990 the hotel’s former ballroom became the trading floor of the Shanghai stock-exchange.

The reopening of the Shanghai stock-exchange, after having been closed by the communists in 1949, was both symbolic and instrumental in China’s transformation to a ‘socialist market economy’. The Chinese economy has since grown by about 49 times since 1990 and about 15 times since 2000.

In 2010 China had succeeded Japan to become the world’s second largest economy.

By 2021 China’s stocks¹ had peaked. Since then their value has halved - a sign that China’s goal to surpass the US as the world’s leading economy is now in trouble.



CHINA DEBT

CHINA'S ECONOMY HAS QUADRUPLED SINCE THE 2008 FINANCIAL CRISIS, BUT OVERALL DEBT EXPANDED BY NINE TIMES. CHINA'S TOTAL DEBT, GOVERNMENT, CORPORATE AND HOUSEHOLD, NOW STANDS AT \$52 TRILLION, ALMOST THREE TIMES THE SIZE OF ITS ECONOMY.

China's economic malaise is attributable to property, which makes up 25% of economic activity and 70% of household wealth. China had been building 15 million new homes a year – five times as many as the US and Europe combined². Property was thought to be a safe investment, with over 65 million unoccupied homes being used as store of value - enough to house the population of France. But now prices for existing homes have fallen by at least 15% and as much as 25% in some neighbourhoods. Sales of new homes have declined by over a third from a year earlier. More than 50 property developers are in financial distress, unable to finish hundreds of thousands of pre-sold homes financed with lifetime savings and mortgage debt.

China's boom-to-bust property market is a growing source of systemic risk in a financial system overburdened with debt.

China's provinces and cities now owe \$14 trillion, equivalent to 85% of China's gross domestic product³. Around \$9 trillion is 'hidden' within local government financial vehicles (LGFV) - companies set up by local governments to borrow for them to circumvent a ban on bank borrowing and selling bonds. This off balance-sheet funding drove the largest infrastructure boom the world has ever seen. Guizhou province, one of China's poorest, set up 110 LGFVs to fund its grand vision of building 11 airports, over 1,000 km of high-speed railways and 10,000 km of new roads. It is also now home to 49 of the 100 tallest bridges in the world.

Untravelled roads and bridges, unused railways and airports, unoccupied office and apartment buildings - many of these projects will never generate enough income to cover the interest.

Local governments had bridged the gap with income from land sales, but the property downturn has cut the amount of land sold for development in half this past year. This has eviscerated local government finances, with interest payments accounting for up to a third of some budgets. More than 80% of LGFVs do not have enough operating cash to cover interest⁴.

Guizhou province could be the 'canary in the coal-mine' after publicly calling on Beijing for a bail-out, to avert defaulting on its \$366 billion debt.



China's banks are likely to be burdened with the huge cost of rescuing local governments. Their debts makes up 29% of banks total loan book⁵. Loans to property developers account for another 7%⁴. The state-owned banks numbers for 'non-performing' loans of debt-laden municipalities and ailing property developers do not yet appear to give cause for concern. But investors certainly fear the worst is yet to come:

CHINA'S TOP FIVE BANKS TRADE AT AN AVERAGE 0.35 PRICE/BOOK RATIO, I.E. THEIR SHARE PRICES DISCOUNT THE VALUE OF THEIR ASSETS BY 65%. EITHER CHINA'S MEGA-BANKS ARE EXTRAORDINARILY UNDERVALUED OR THEY ARE PRICED FOR TOTAL DISASTER.

China's \$3 trillion shadow banking sector, roughly the size of Britain's economy, could also become another casualty. China's shadow banks offer high-yield trust products, attracting the savings of individual investors, which are then pooled into loans to high-risk borrowers. Over one hundred of these trust products, worth \$6 billion, defaulted in just the first seven months of 2023⁶. Property investments accounted for almost three-quarters of the defaults by value. Many more are teetering on the edge. Shadow banks account for almost 10% of total loans in China, so a crisis of investor confidence in their trust products could destabilise a key source of finance vital to the economy.

Could China be in danger of entering into a doom loop? As the property downturn stresses the banking system, it triggers a reduction in lending, this depresses growth, which in turn deepens the property slump, thereby self-reinforcing the downward cycle. This risk is stoking fears an even larger financial crisis maybe looming.

All of this comes at a time when China's economy is weakening. The era of double-digit growth is over, with growth set to fall below 4% in the coming years, according to the International Monetary Fund. Capital Economics, a London-based research firm with a team of over 70 economists, estimates China's trend growth has already fallen to 3% and will fall further to 2% in 2030. At these growth rates, China's national income will not support its debt mountain growing at its previous 11% yearly rate. Moreover, the use of debt to fund projects whose economic benefits are less than their economic costs is just adding more fuel to the fire.

China's economic model based on borrow to build is broken.



CHINA EXIT

A "TICKING TIME BOMB" IS HOW PRESIDENT JOE BIDEN DESCRIBED CHINA'S ECONOMY.

A prominent financial journalist for the Chinese financial magazine Caixin compared the country's economic problems to the Great Depression. He was subsequently banned from social media. Consultants and researchers who help foreign investors to understand China and carry out due diligence are under investigation. As the economic data becomes increasingly negative, government departments have been publishing less of it e.g. youth unemployment numbers will no longer be issued after the official figure reached 21% - unofficially it is thought to be as high as 43%. The lack of reliable information represents a huge hurdle in determining the risk of China suffering a 'Lehman Moment' i.e. when a problem in one company or one component of the economy turns out to be so large that it become everyone's problem.

Beijing has proved adept at averting full-blown financial crises in the past, using its strong grip over the country's banking sector and financial markets. Even if China is spared a sudden shocking dramatic 'Lehman moment', so deep-seated is the economic malaise, it might instead suffer a slow-moving economic crisis that could last years.

Prioritising national security at the expense of economic expansion, an ageing population, a crack-down on entrepreneurs and a widening divide with the West - doubts over China's investability are rising, evident from the record numbers of emerging market funds launched that exclude China. In the first six months of 2023, the largest emerging market ex-China ETF alone attracted a record \$1 billion.

'De-risking' is also causing unprecedented outflows from China. At the half way point this year, foreign holdings of China's stocks and bonds had fallen 17% from their peak⁷. In currency markets, selling Yuan has weakened it to its lowest level since 2007. Most worryingly for the future economy, investment by foreign companies into China has collapsed, having fallen 87% compared to a year ago⁸.

CHINA'S MILLIONAIRES ARE LEAVING – FOLLOWING THE LOSS OF AROUND 10,800 MILLIONAIRES IN 2022, THE COUNTRY WILL LOSE ANOTHER RECORD 13,500 MILLIONAIRES THIS YEAR⁹.



CHINA TECH

CHINA LISTED
COMPANIES HAVE
OVER 3 MILLION
STAFF WORKING IN
R & D

'IN THE LONG TERM, CHINA'S LEADING RESEARCH POSITION MEANS THAT IT HAS SET ITSELF UP TO EXCEL NOT JUST IN CURRENT TECHNOLOGICAL DEVELOPMENT.... BUT IN FUTURE TECHNOLOGIES THAT DON'T YET EXIST.'

This was the startling conclusion of a security think-tank funded by western governments and defence contractors. After tracking research in key technologies, such as defence, space, robotics, energy, environment, biotech, artificial intelligence, advanced materials and quantum computing, its report issued earlier this year, declared China had taken the lead in the race for tech domination.

China is classed as an emerging market, despite having developed into a technology superpower. Its commanding position in 'green' industry is evidence, with three-quarters of the world's solar panels and 97% of the silicon wafers that go into them made in China last year. A Chinese startup is to begin production of ultra-efficient solar panels made from perovskite. These next-generation solar cells will halve the cost of manufacture and be 50%

more efficient than traditional silicon cells. China is home to six of the top ten manufacturers of large-capacity rechargeable batteries, including one that has developed an electric vehicle battery capable of going 1,000 kilometres (620 miles) on a single charge. China is positioning itself to command the next big innovation in rechargeable batteries: replacing lithium with sodium. Chemically the two are similar, but sodium sells for as little as 1% of the price of lithium. Out of 20 sodium battery factories now planned or under construction around the world, 16 are in China.

The importance China's leadership attaches to winning the technology race is revealed by the membership of its Central Committee, China's top political body, 40% of whom have science and technology backgrounds¹⁰.

The adoption of robots is a top policy priority - China now has 12 times the rate of robot use in manufacturing than the U.S. China is also committed to becoming the global leader in AI, funding start-ups, academic research and 'moonshot' projects, the number of AI enterprises in the country already exceeds 4,300. In 2022 China ranked second globally with 316 unicorn companies, or startups valued at more than \$1 billion.

Transitioning from traditional to technological manufacturing,

CHINA'S ULTIMATE GOAL IS TO ELEVATE ITS ECONOMY TO THE WORLD'S NUMBER ONE SPOT BEFORE 2049 - THE 100TH ANNIVERSARY OF THE PEOPLE'S REPUBLIC OF CHINA.

This is for your information and not an invitation to invest

IF CHINA SUCCEEDS IN ITS AMBITIONS, INVESTORS MIGHT STILL BE LEFT DISAPPOINTED. FROM 1992 TO 2022 CHINA'S ECONOMY WENT FROM \$493 BILLION TO \$17.9 TRILLION. THAT EQUATES TO A STAGGERING GROWTH RATE OF OVER 12% P.A.

AT THE END OF 1992, THE MSCI CHINA INDEX WAS LAUNCHED, COVERING 85% OF CHINA STOCKS. OVER THE LAST THREE DECADES THIS INDEX GROWTH RATE WAS JUST 0.9% P.A.

INVESTORS IN CHINESE STOCKS CLEARLY HAVE NOT BEEN WINNERS IN CHINA'S RISE.



Sources

1. MSCI 31/8/23
2. The Economist
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4. UBS
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6. Use Trust
7. Bloomberg
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9. Henley & Partners
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ALL INVESTMENTS INVOLVE THE RISK THAT YOU MAY NOT GET BACK ALL THE MONEY YOU INVESTED

THE VALUE OF AN INVESTMENT CAN CHANGE QUICKLY AND MAY GO DOWN AS WELL AS UP

PAST PERFORMANCE IS NOT A RELIABLE INDICATOR OF FUTURE RETURNS

INVESTORS SHOULD BUILD A DIVERSIFIED PORTFOLIO TO SPREAD RISK

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