BARINGS INVESTMENT INSTITUTE

28 September 2022

RESEARCH NOTE

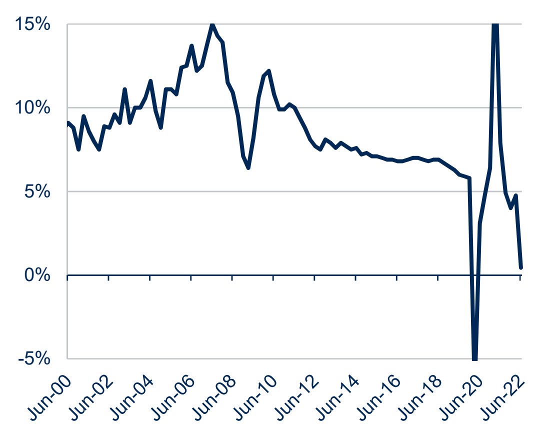
China: This Time is Different

Cem Karacadag, Boston

The Chinese economy is facing its hardest test in over two decades, and it will not come out of it easily.

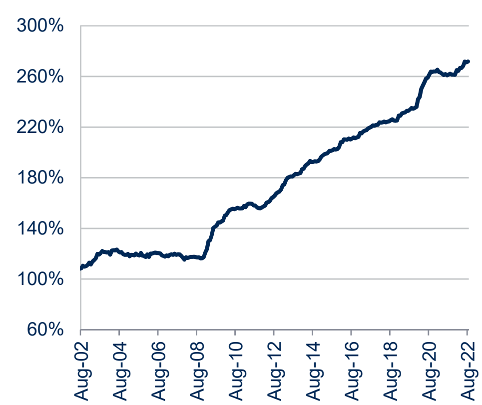
The Chinese economy grew without interruption, year after year, at very high rates for more than 20 years and skirted the initial COVID shock through a combination of massive lockdowns and luck. Urbanization, foreign technology, and productivity gains drove many of these miracle growth years. However, since the global financial crisis of 2008, countercyclical credit booms have sustained growth at the expense of levering up households, corporates, and local governments with almost 300% of gross domestic product (GDP) in debt.

CHINA REAL GDP (Y/Y)



Source: Haver. As of August 31, 2022.

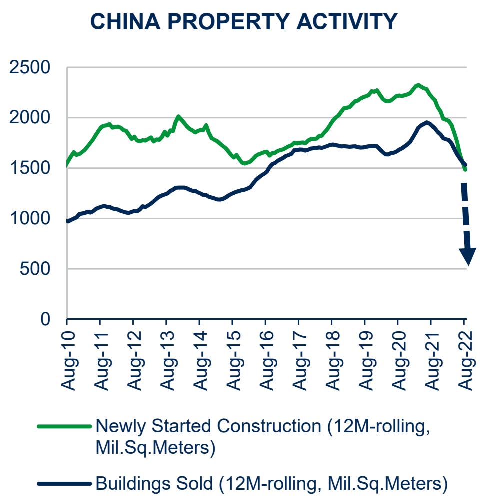
CHINA TOTAL SOCIAL FINANCING AS A % OF GDP



Source: Haver. As of August 31, 2022.

The latest real GDP data for Q2 2022, which was flat year-over-year (Q1 2022 versus Q2 2021), and negative quarter-over-quarter (Q2 2022 versus Q1 2022), is a sure sign the Chinese economy is wobbling. Higher-frequency monthly data through August 2022 paint the same picture. Unlike old times, there is no more room to lever up again. In fact, financial stability is now a risk factor and deleveraging has become an unavoidable policy objective at a difficult time.

The property sector downturn is severe and the prospects for how and when it will stabilize remain uncertain. Home sales and new construction starts are diving, and we expect both sales and starts to continue falling in 2023; we expect they will stabilize as low as levels from almost 10 years ago. Meanwhile, because many households have invested two-thirds of their savings in property, the government is limiting sellers' ability to lower prices, which prevents prices from reaching market-clearing levels and puts the burden of adjustment on sales volumes. The unintended consequence is to slow the recovery in end-buyer confidence in the housing market. The property sector so far has not responded well to piecemeal support measures—because of weak buyer sentiment as well as COVID-related restrictions on mobility. China's economic growth rate will inevitably suffer during the property sector's multi-year adjustment process, which, until recently, contributed directly and indirectly one-quarter of China's annual GDP.



Source: Haver. As of August 31, 2022.

Sources: Haver and Bloomerg. As of August 31, 2022.

Does this mean the Chinese economy will crash and take the world or other emerging markets down with it? Our answer is a resounding "no" thanks to China's still-strong external competitiveness. Since 2020, China's external trade surplus has surged to $400 billion annualized, which, at the same time, is the mirror image of the country's high savings minus investment balance. China's high savings rate is a key financial strength because it means that the economy internally generates (i.e., saves) enough to finance domestic public and private investment, without relying on foreign savings.

However, there is a catch: a sizable and increasing portion of Chinese savings is leaking abroad—the same amount of its external trade surplus because Chinese residents are finding fewer opportunities to invest at home. Residents taking their money overseas in large sums signifies a negative vote of confidence in the Chinese economy that we take seriously and continue to monitor closely.

While the Chinese economy has faced cyclical headwinds in the past, this time is different because economic growth is no longer the singular policy goal. There are now multiple objectives, which limit the degrees of freedom in policy:

(1) High leverage means the economy cannot level up more.

(2) Wealth tied up in housing means authorities cannot allow enough downward price flexibility in home prices to find a new supply versus demand equilibrium.

(3) Capital leakage abroad means the government cannot ease monetary policy as much as the weak economy may warrant.

(4) Monetary policy is also constrained by the turnaround in the China-U.S. bond yield differential, which has moved 250bp against China, from +150bp in Q4 2021 to -100bp currently. We do not expect further interest rate cuts from the PBOC.

(5) Fiscal policy is constrained by the collapse in land sales, which are a key source of local government revenues.

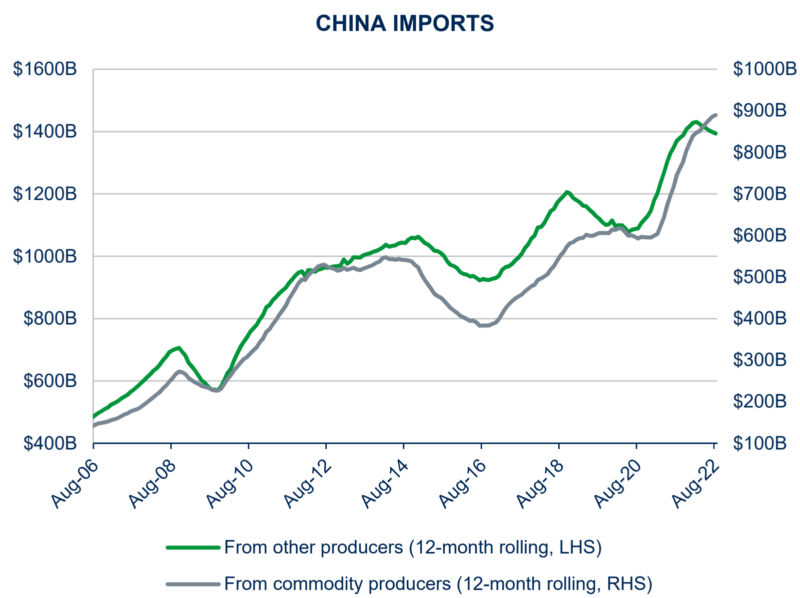
Source: Haver. As of September 22, 2022.

Source: Haver. As of August 31, 2022.

(6) China's zero-COVID policy, which we do not expect will change, means continuing periodic interruptions to mobility, investor/buyer sentiment, and activity.
(7) Making China self-sufficient means turning inward and being less-friendly toward foreign investment.
(8) "Common prosperity" means more regulatory intervention in the economy, just when investor sentiment is weak.

The upcoming National Congress of Chinese Communist Party, scheduled to open October 16, is unlikely to result in significant changes in political leadership or policy objectives. We expect President Xi Jinping to remain firmly in charge of China and for the government's main goals and policies to remain the same.

A weaker Chinese economy will likely pose headwinds for the global economy as well in the coming quarters. As of August 2022, China imported $900 billion worth of commodities on an annualized basis from commodity producers worldwide and another $1.4 trillion in goods from non-commodity producers, in developed and emerging markets worldwide. This makes it particularly important for investors to understand the dynamics of this downturn in China and how it is so different from previous cycles.



Source: Haver. As of August 31, 2022.

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed by Barings or any other person. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, and Baring Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"). Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

22-2447588