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Flash Note

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China needs its own 'Mario moment'

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Viewpoint

- China faces a number of economic headwinds. Restoring confidence is what will get equity markets moving again.
- Bold action is needed, but perhaps not in the form of massive government spending.
- The European experience from the early 2010s may offer some clues.

Debt. Demographics. Deflation. Even the casual news observer would find it hard to avoid the seemingly endless headlines on China's economic woes. It is undeniable that China's economy faces headwinds, and it should shock no one that China's GDP growth will slow. From its peak in February 2021, to August's end, Chinese equities are down more than 50%.

On closer inspection, however, there is more than meets the eye. The reality of the situation is China's current perils are being exacerbated by government policy, introducing a cyclical element that at present is inflicting further damage to the economy.

Looking to Europe

At first glance, the European debt crisis, starting in 2009 in Greece, bears little resemblance to the issues that China faces today. While the circumstances, characters and policy options are different, there is a common theme between Europe and China's present dilemma.

After a series of rolling crises in the early 2010s, government bond yields in some weaker European countries were surging (meaning investors were selling bonds). Mario Draghi, then President of the European Central Bank, spoke at a London conference in defense of the union:

"[we are] ready to do whatever it takes … And believe me, it will be enough."

This seminal comment proved to be a turning point in the relentless rise of bond yields, sending a clear message to the market that the ECB had the ability and willingness to step in and drive bond yields lower (whether the ECB actually had a mandate do this remains debatable).

A week later, the ECB announced a program to buy bonds of distressed countries, known as Outright Monetary Transactions. The key irony of the program (and Mr Draghi's comment) was that it was never actually utilised, as bond yields had already peaked, and headed lower. The stated intention was enough. In our view, it was a much-needed injection of confidence that put a floor under markets.

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China's 'Mario moment'

As it relates to China, we think the risk of wider contagion and economic crisis is low. A closed capital account, control of the banking system and significant efforts to reduce off-balance sheet exposures in recent years makes it very unlikely China will suffer a 'Lehman' type event. We believe what is required in the near term to help China out of its cyclical funk is greater confidence. Central to this idea is the restoration of confidence in the property market, given its role in economy (estimated at 30% of GDP) and as a store of wealth for Chinese consumers.

Chinese officials have a long history of pragmatic policy making, yet today we are seeing an unwelcome and historically unusual delay to any major policy moves. Ideology, perhaps, is playing a larger role than previous downturns. We think China's pragmatic framework still has relevance but clearly the pain threshold has risen before greater policy action will be taken. Policy makers have plenty of tools available to them. Will they blink? How bad does it have to get?

Recent moves by Chinese authorities to lower down payments, mortgage rates and extend credit have been welcomed by markets, and reports of increased real estate buyer activity are also encouraging. Whether this will be enough to restore much-needed confidence remains an open question. The stabilisation of property prices is a key signpost for China's economic recovery, but when dealing with the nebulous concept of confidence, it is virtually impossible to know on an ex-ante basis.

Parting thought

In the longer term, Chinese policy makers will need to make big decisions about its future growth model as well as the interaction between public and private enterprise. In the near term, with negative sentiment increasing and relatively cheap valuations, we remain constructive on Chinese equities and continue to find attractive investment opportunities.

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