



China: Reopening Should Drive Growth

January 20, 2023

After a year of anemic growth—by China’s standards—we expect a recovery in Chinese economic activity to gradually take place in 2023. The government has abandoned its zero-COVID policy and re-pivoted to growth, and the reopening, combined with a benign inflationary environment that gives China’s policymakers room to increase stimulus, we believe is a reason for optimism in 2023. That said, major policy questions and geopolitical risks cloud the outlook.

Note: Due to rapidly changing circumstances in China, this article has been updated since it originally appeared in our 2023 emerging markets outlook paper.

How has the Chinese economy performed in 2022?

Vivian: Consensus estimates for gross domestic product (GDP) growth in 2022 are about 3%, which would be China’s lowest in several decades, except for 2020, the first full year of the COVID outbreak. While 3% growth compares well with the developed economies, it is equivalent to a recession in China.

Exports were quite strong in the first half of 2022, driven by both the global economic recovery and the Russia-Ukraine war, which exacerbated supply shortages and led to additional demands for Chinese exports. But domestic consumption has been very weak in 2022. This is primarily due to lockdowns under zero-COVID, which are creating physical constraints on consumer activity while also severely damaging consumer and business confidence.

At the start of 2022, there were hopes that more fiscal stimulus or infrastructure spending would materialize, but it did not. Given the lockdowns, and with local governments diverting resources to manage COVID, the government likely assumed that more aggressive spending would be ineffective.

Clifford: Coming into 2022, investors did not expect the government to be so passive in dealing with falling property prices and so rigid in addressing COVID. The property market cannot make a comeback when public mobility is far below normal due to lockdowns. This has wider repercussions because property is entwined with so many other economic sectors.

A third surprise in 2022 was the deterioration in U.S.- China relations, in particular the sanctions on China's access to high-end chip technologies. This will be a setback as China tries to advance its high-tech industries.

What is the latest on the zero-COVID policy? How does it relate to China's Common Prosperity and growth goals, if at all?

Vivian: The Chinese government has drastically abandoned its zero-COVID policy in the past couple of months. The policy direction, intensity, and speed surprised the markets. Zero-COVID and Common Prosperity are linked, but they also conflict in some ways. The government's strict COVID policy acknowledges the public's desire for health and security. But there is a divergence of attitudes within China's vast population. The elderly and less urbanized populations, in general, are much more fearful of COVID and more suspicious of vaccines than younger and more urbanized groups. This puts the Chinese government in a difficult position. It may have vast authority and power, but it also has unlimited liability for protecting the public's health.

Meanwhile, zero-COVID has hurt growth, and the unemployment rate among younger people is more than 20%. The government cannot tolerate this either because it will lead to social unrest. So it has to solve the dilemma.

It seems increasingly clear to the Chinese government that reopening and resuming growth have become an acute priority given the anemic economic growth and increased discontent they saw among the people after prolonged lockdowns and restrictions.

In the meantime, the pandemic has evolved globally, with dramatically reduced mortality as most countries have fully reopened. And China's initial plan to protect public health interests and maintain economic growth at the same time has not worked. I had expected China to gradually exit its zero-COVID policy in 2023 precisely due to the factors mentioned above, but was nonetheless surprised by the fast pace.

In the near term, we expect disruption to the Chinese economy as a result of surging infections and increased deaths post-reopening. Once infections subside, economic activity should resume and recover throughout 2023, similar to the reopening experiences in other countries. I believe consumption and services would benefit from reopening the most.

Clifford: China's zero-COVID policy has finally come to an end after three years of exhausting implementation. The government probably realizes it can't afford to delay the reopening of the economy any further when economic data releases have been weak and people have been suffering from restricted mobility for too long. Apparently, there has been a shift in the government's attitude on COVID policy such that it now sees delivering growth and

prosperity to be as important as protecting lives. The policy update doesn't contradict the broader goals for Common Prosperity; it is just that the priorities have been reset and focuses rebalanced to tilt toward managing risk while reviving growth.

What indications of future economic policy came out of the 20th Party Congress?

Vivian: One new theme was national security—not only regarding U.S.-China tensions and geopolitical risk but also embracing food safety, energy safety, supply chain safety, cybersecurity, and even ideological security. Other than that, the key messages were similar to what the government under President Xi Jinping has promoted in the past. One exception is that policymakers seem to be putting more emphasis on high-quality growth—focusing on the quality and sustainability of growth versus the magnitude of growth.

The Western media portrayed the new party leadership alignment as Xi surrounding himself with loyalists, but that is too simplistic. Several people added to the standing committee of the Chinese Communist Party Politburo, the seven-person inner circle that leads policymaking, are all from China's southern provinces, which are the wealthiest and most pro-growth parts of China. These new members have solid track records of successfully leading economic growth in various towns, cities, and provinces in these areas, including Zhejiang, Fujian, Guangdong, and Shanghai.

The Central Economic Work Conference (CEWC), held in mid-December and convened by the new Central Committee of the 20th Party Congress, stated “unwavering” support for private companies and laid out the growth agenda for 2023. This largely reflects the unchanged pro-growth and pro-market stance of the new leadership of the party, although the market remains skeptical. The next key meeting for the economic policy is the State Council's reporting to the National People's Congress and the Chinese People's Political Consultative Conference in March 2023, when the new premier and leadership team of the State Council will be confirmed. It's important to wait and see the new leadership's further economic policies and subsequent execution to properly assess and reassess the China investment case.

Clifford: It is likely a good thing from an economic perspective that the congress is over. These events are preceded by months of lobbying and political wrangling, which means the political agenda was prioritized in 2022 at the expense of economic policy.

I do not foresee major changes in monetary policy, which has been moderately accommodative for the past two years. For now, China does not face high inflation like Europe and the United States, so China can keep interest rates low and stimulate growth, which gives it a competitive edge relative to the rest of the world.

What is your projection for China's GDP growth in 2023?

Vivian: The consensus GDP growth forecast for 2023 is about 5%, which factors in certain benefits of reopening. There could be upside to the forecast if the economy and consumption recover much faster and stronger post-reopening, combined with more effective property market policies, as well as monetary and fiscal stimulus. I believe the improved regulatory backdrop for the internet industry and continued growth of domestic technology substitution and energy transition trends should also help drive upside to GDP growth in 2023.

Exports drove growth in 2022, especially in the first half, when both demand and commodity prices were strong.

We are unlikely to see accelerated export growth in 2023 amid a global economic slowdown and coming off a tough comparison year, so the Chinese economy will have to rely more on domestic consumption and demand.

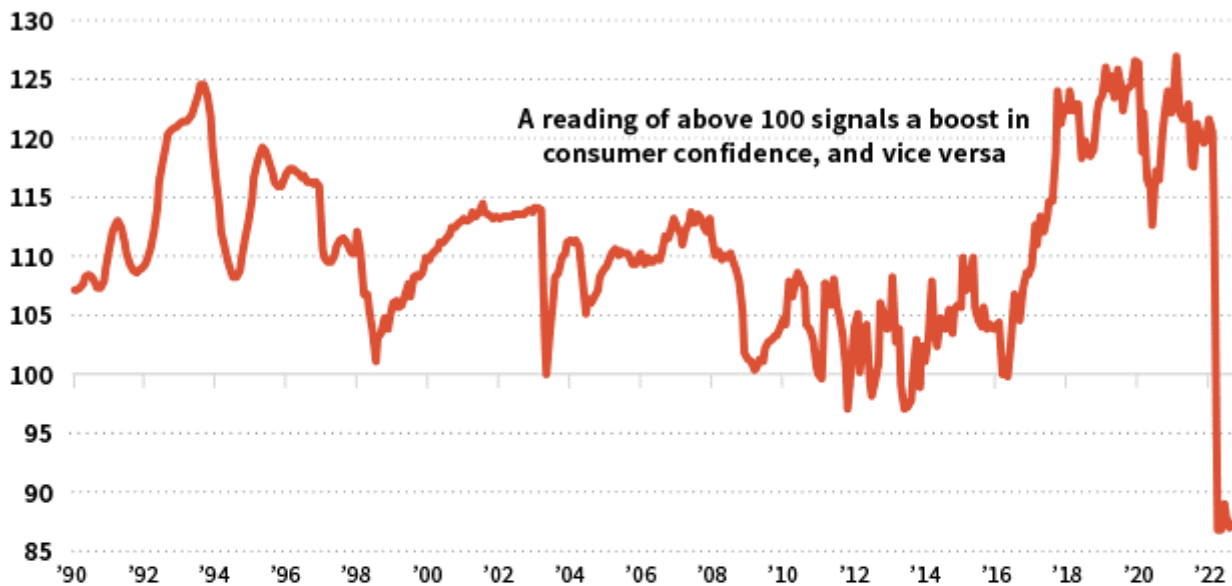
The collapse in consumption in 2022 was due to both an inability to consume (because of lockdowns and closures) and unwillingness to consume because of a collapse of confidence. Essentially, people were hoarding money. China's household savings rate jumped to 40% in 2022, well above its historical level of 25% to 30%. The excessive savings mean that pent-up demand could be strong as the country continues reopening. I believe this should provide strong support for consumption recovery and GDP growth in 2023, with potential upside.

Clifford: With the end of China's zero-COVID policy and both domestic and international travel now fully enabled, I believe China's economy will gradually return to its full growth potential as things continue to normalize. 2023, however, is set to be a challenging year on the global front, as global growth is slowing, inflation remains high, and the war in Europe is prolonged. Chinese and Asian exports have already been trending down in recent quarters, so export growth should be less of a contributor for China's economy this year. However, the strong expected rebound in consumption due to pent-up demand could nevertheless act as an effective tailwind for China to deliver above-average growth this year.

Lockdowns Destroy Chinese Consumer Confidence—But Record Savings Set the Stage for a Strong Recovery

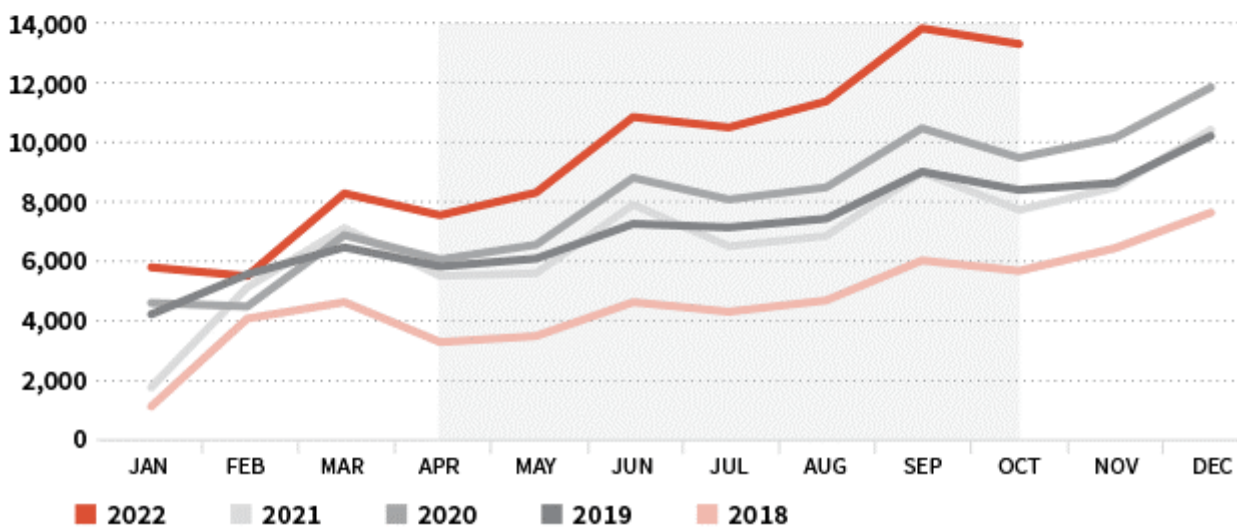
China’s zero-COVID policies have caused consumer confidence to plummet and led to a drastic increase in personal savings. If China continues relaxing its COVID policies in 2023, it could unleash massive amounts of pent-up demand.

China’s Consumer Confidence Index (Monthly)



Sources: Autonomous Research and William Blair, as of January 9, 2022.

Net Change in Chinese Household Deposits (in Billion Yuan)



Sources: Evercore ISI and William Blair, as of October 2022.

How did China’s debt markets perform in 2022, and what are your expectations for 2023?

Clifford: On an unhedged basis, Chinese government bonds, based on the J.P. Morgan Government Bond Index-

Emerging Markets (GBI-EM) Global Diversified, have returned –6.36% in 2022 year-to-date through December 13, 2022. While negative, this is significantly better than the broader J.P. Morgan GBI-EM, which is down 13.21% year-to-date.

The offshore renminbi has fallen 8.92% against the U.S. dollar in 2022, so on a hedged basis, stripping out currency effects, year-to-date performance in Chinese government bonds has been positive. The benign inflation environment and easier monetary policy helped push yields lower and enhance returns. China was definitely an outlier among government bond markets in 2022.

Looking forward, interest rates in China are moving opposite to global interest rates, which makes the Chinese government bond market currently one of the most expensive. Two years ago, the Chinese 10-year bond offered 175 basis points of pickup over 10-year U.S. Treasuries, but now that relationship has inverted—so the Chinese bond market has lost its competitive edge as global interest rates jumped.

I do not expect Chinese interest rates to rise much in 2023—unless consumer spending comes in too strong or unexpectedly high food prices make inflation a real threat.

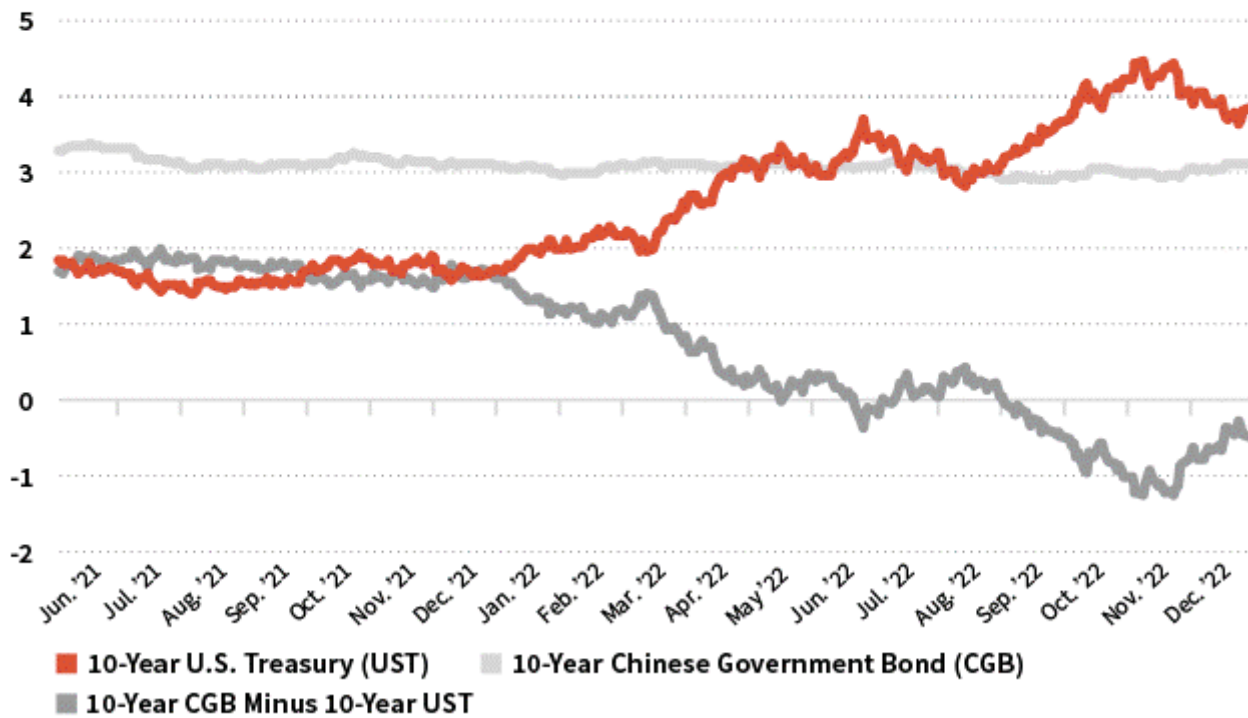
We see value in having some exposure to the Chinese government bond market because of the resilience of the underlying economy, but we do not believe it warrants an overweight position. I believe the technicals of investing in China's lower-return fixed-income market, such as Chinese government bonds or onshore credits, are likely to weaken as the broader reopening of China could inspire reallocation from fixed income to stocks.

I believe other markets are more likely to deliver better returns, especially if central banks around the world start pivoting away from rate hiking.

Chinese Bonds Lose Their Competitive Edge

Inflation has remained subdued in China, allowing China’s central bankers to gradually reduce interest rates to spur growth while the United States and Europe have drastically raised rates. This divergence has made the Chinese bond market one of the most expensive in the world.

Relative Valuation: 10-Year Chinese Government Bond Yield vs. 10-Year U.S. Treasury Yield



Source: Bloomberg, as of December 13, 2022.

How did Chinese equity markets fare in 2022? What opportunities do you see for quality growth investors in 2023?

Vivian: Even though Chinese interest rates declined in 2022, China’s equity market returns resembled what you would expect to see in a rising-rate environment. Higher-valuation, growth-oriented sectors dramatically underperformed lower-valuation, lower-quality stocks.

In addition, valuations for Chinese quality growth companies contracted dramatically in 2022, and consumption and economic activity overall were hurt by ongoing COVID lockdowns and property issues. This made for a very challenging environment for investors focused on quality growth.

Looking ahead to 2023, we are focusing on reopening as a key theme. Beneficiaries could be consumer, internet, and digital economy companies.

We have exposure to quality growth companies in the consumer space—the leading liquor company, the leading duty-free company, the leading ingredients company, the leading cosmetics company, and so on. We believe they have the potential to benefit strongly as the reopening plays out.

We also have substantial exposure to internet companies. These are out of favor among global investors, but we take a long-term view. Valuations now appear attractive, in our view, and regulatory measures affecting these companies have been stabilizing.

Another longer-term structural story we like is energy transition, including electric vehicle batteries, solar panels, and companies related to these industries. These higher-valuation segments underperformed traditional energy companies in 2022, but we remain bullish on the long-term opportunities related to the transition to a lower-carbon economy.

We pay close attention to fundamental corporate earnings, which are already in recovery after earnings expectations came down dramatically year-to-date. If you combine earnings recovery with attractive valuations and a stabilizing regulatory environment, plus reopening and policy support, we believe 2023 may be a good year for quality growth investors.

How does the geopolitical environment affect China's investment landscape?

Vivian: Clamping down on China has become a bipartisan effort in the United States. This creates a risk factor for investors that has little to do with fundamentals. If you look at restrictions on semiconductor sales to China, for example, China could deal with the problem technically and practically over time, but it raises bigger concerns about the investability of Chinese equities. A U.S.-based investor must ask whether the U.S. government may eventually put China-based tech companies on the restricted entity list.

Clifford: In the bond market, we are dealing with the same investability issue. Several Chinese companies deemed to have close connections to the military have suddenly been put on the restricted list. You cannot research this kind of risk, because you do not know the rationale behind it and it is hard to anticipate. It also raises the question of whether these restrictions will extend to the sovereign side. If we talk about tail risks in Chinese investment, this is a big one.

Final Takes?

Vivian: Growth-oriented, higher-valuation companies underperformed in 2022 despite China's accommodative monetary environment. If you combine earnings recovery with attractive valuations and a stabilizing regulatory environment, plus gradual reopening and continued policy support, we believe 2023 may be a good year for quality growth investors.

Clifford: Being able to manage down the risk from this abrupt end of China's zero-COVID policy is the key now. If it proves a success, the economy could surprise to the upside. While we believe a strong return in domestic consumption looks a lot more promising as we start 2023, better-than-expected export performance is also possible as the prospects for a global economic soft landing improve.

Vivian Lin Thurston, CFA, partner, is a portfolio manager on William Blair's global equity team.

Clifford Lau, CFA, is a portfolio manager on William Blair's emerging markets debt team

Want more insights on the economy and investment landscape? [Subscribe to our blog.](#)

The J.P. Morgan GBI-EM tracks the performance of bonds issued by emerging market governments and denominated in the local currency of the issuer, and is broader than the similar J.P. Morgan GBI-EM Global Diversified. (Index information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The indices are used with permission. The indices may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright 2022, JPMorgan Chase & Co. All rights reserved.)



Emerging Markets 2023 Outlook Series

[Part 1 | Outlook 2023: Better Than Feared](#)

[Part 2 | Emerging Markets Equities: Positioned for a Rebound?](#)

[Part 3 | Emerging Markets Debt: Clearer Skies Ahead?](#)

[Part 4 | China: Reopening Should Drive Growth](#)

Disclosure:

This content is for informational and educational purposes only and not intended as investment advice or a recommendation to buy or sell any security. Investment advice and recommendations can be provided only after careful consideration of an investor's objectives, guidelines, and restrictions.

Information and opinions expressed are those of the authors and may not reflect the opinions of other investment teams within William Blair Investment Management, LLC, or affiliates. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information is current as of the date appearing in this material only and subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. This material may include estimates, outlooks, projections, and other forward-looking statements. Due to a variety of factors, actual events may differ significantly from those presented.

Investing involves risks, including the possible loss of principal. Equity securities may decline in value due to both real and perceived general market, economic, and industry conditions. The securities of smaller companies may be more volatile and less liquid than securities of larger companies. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks. These risks may be enhanced in emerging markets. Different investment styles may shift in and out of favor depending on market conditions. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result.

Investing in the bond market is subject to certain risks including market, interest rate, issuer, credit, and inflation risk. Rising interest rates generally cause bond prices to fall. High-yield, lower-rated, securities involve greater risk than higher-rated securities. Sovereign debt securities are subject to the risk that an entity may delay or refuse to pay interest or principal on its sovereign debt because of cash flow problems, insufficient foreign reserves, or political or other considerations. Derivatives may involve certain risks such as counterparty, liquidity, interest rate, market, credit, management, and the risk that a position could not be closed when most advantageous. Currency transactions are affected by fluctuations in exchange rates; currency exchange rates may fluctuate significantly over short periods of time. Diversification does not ensure against loss.

There can be no assurance that investment objectives will be met. Any investment or strategy mentioned herein may not be appropriate for every investor. References to specific companies are for illustrative purposes only and should not be construed as investment advice or a recommendation to buy or sell any security. Past performance is not indicative of future returns.

Copyright © 2020 William Blair & Company, L.L.C. "William Blair" is a registered trademark of William Blair & Company, L.L.C. No part of this material may be reproduced in any form, or referred to in any other publication, without express written consent.