# China's Unwavering Growth Journey

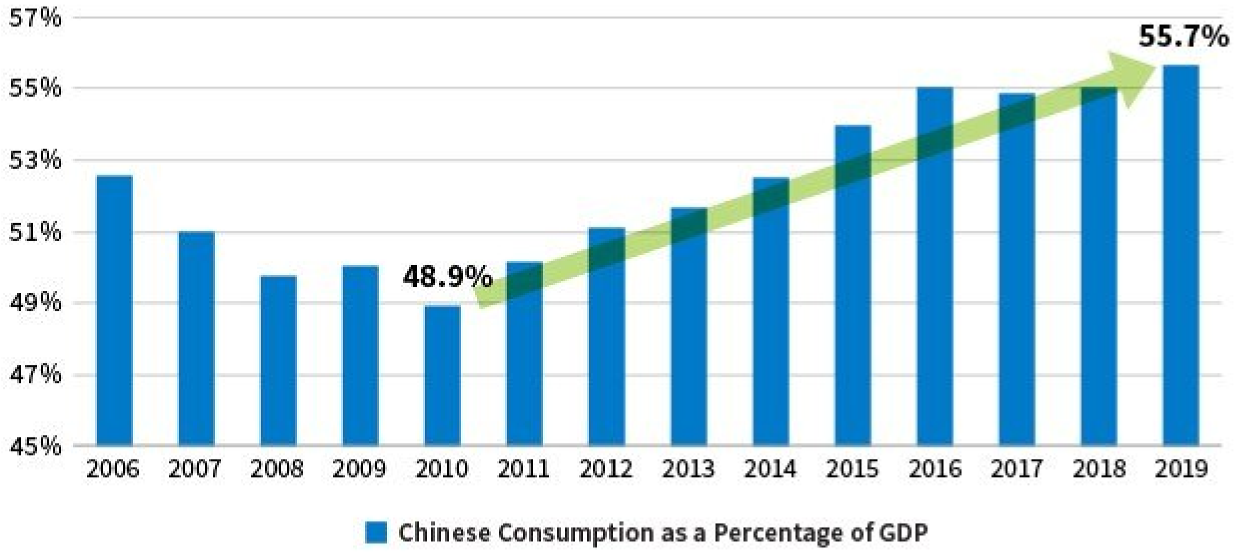
March 11, 2021

China led the world into the COVID-19 pandemic and was the first country to emerge. As we look ahead to the remainder of 2021, what does the modern Middle Kingdom have in store? We asked Vivian Lin Thurston, CFA, partner, a portfolio manager on our China A-Shares Growth strategy, and Clifford Lau, CFA, a portfolio manager on our EM debt team.

**China was the first country to go into the COVID-19 crisis, and was the first one coming out. How does its recovery look at this point?**

**Vivian:** Chinese gross domestic product (GDP) has continued to recover strongly after contracting 6.8% year-over-year in real terms in the first quarter, the height of the pandemic for China. It is the only major economy in the world to post positive GDP growth in 2020 (2.3% in real terms). And that recovery should continue, with current consensus estimates putting 2021 real GDP growth at 8.2%.

**China Continues to Shift to a Domestic-Consumption-Driven Economy**




Sources: World Bank and William Blair, as of December 2020.

**Are we seeing any changes as a result of COVID-19?**

**Clifford:** I think COVID-19 has created a stronger impetus for China to make the changes needed to address the past few years of U.S.-China trade frictions. The idea of dual-circulation strategy was invented exactly to cultivate those changes, de-emphasizing globalization and focusing more on domestic and regional growth.

**How big of a role has fiscal stimulus played in China's recovery? Is it sustainable?**

**Clifford:** Fiscal stimulus has certainly played an important role in China's recovery, though not to the extent we have seen in other countries. Many of China's export competitors have seen massive production disruptions, putting China, which emerged from lockdown much sooner, in a good position to fill the gap. That reduced pressure on the government to stimulate the economy via fiscal spending. The country's fiscal deficit of 4% to 4.5% in 2020 is manageable and below the global norm.

**Vivian:** The stimulus, in my view, was very sensible because countries facing a disruption event like a pandemic need a jumpstart. The stimulus was also well structured (with around 30% coming from tax and fee reduction, which directly benefits consumers and enterprises, and addresses structural issues at the same time). In addition, that amount of stimulus won't be necessary in 2021, once the economy gets back to normal growth.

**Much of the fiscal support was focused on the corporate sector and infrastructure investments, leading manufacturing to outperform services. How do you see the transition from investment to consumption taking placing in 2021?**

**Vivian:** Inherently, after pandemics, manufacturing tends to recover sooner and respond to stimulus faster than services given their different natures. It takes longer for consumers to feel safe and comfortable consuming again, while manufacturing resumes immediately.

But we have seen services catch up quickly in recent months, and even surpass manufacturing. Since May 2020, the average monthly Caixin China services PMI is up more than 7% year-over-year, ahead of manufacturing PMI, which is up around 4%. This indicates the recovery in services consumption is taking hold very nicely.

**Clifford:** The transition to consumption is already taking place as mobility increases and the servicing sector recovers more. The return of wage growth should also lend great help for domestic consumption in the coming year.

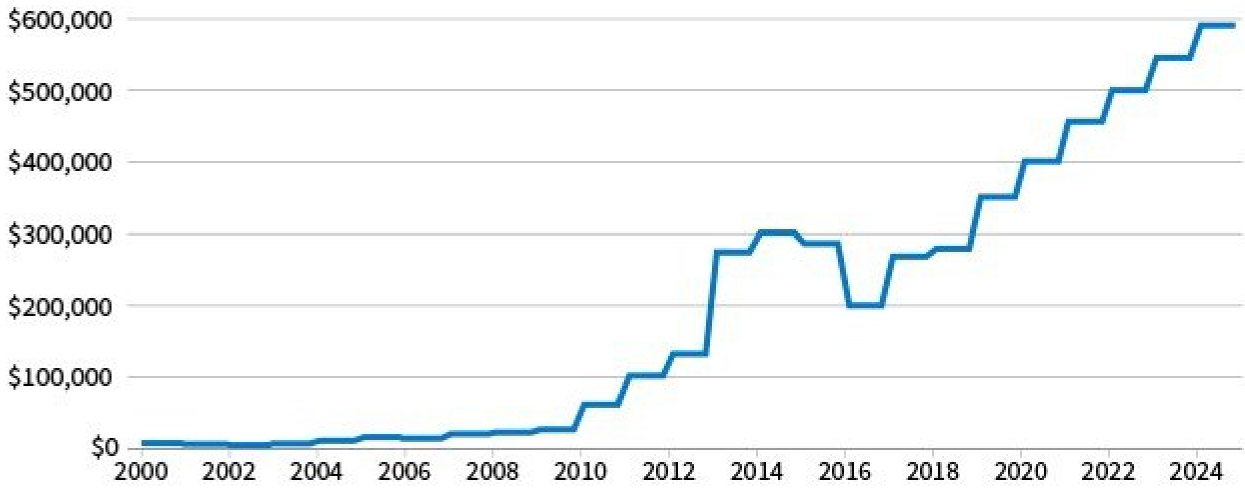
**Vivian, what drove Chinese equity performance in 2020, and do you see the same factors continuing in 2021?**

**Vivian:** There were two key drivers of Chinese equity performance in 2020: better-than-expected management of the COVID-19 pandemic, and swift and effective stimulus. Those drivers will likely decline in relevance in 2021. However, quality growth companies (which we seek out) tended to be the bigger beneficiaries of the recovery and stimulus, and outperformed the overall market 2020. We believe that has the potential to continue in 2021.

**Clifford, what do you think will drive debt performance in 2021?**

**Clifford:** The performance of Chinese government bonds in 2021 will likely be a balancing act. We should see continued offshore inflows as local bond markets gain more attention from overseas investors due to a high yield gap (versus other developed markets) on the valuation front and expected index inclusion on the technical front. But this healthy offshore demand will likely be tempered by expected strong Chinese growth and the potential for inflationary risk. This will likely cap rates.

## Chinese Debt Securities Held by Non-Residents (In Millions USD)




Source: Oxford Economics, as of December 2020. Data after 2020 is estimated

**Has your investment case for China equities and debt changed?**

**Clifford:** Not on the government bond side. The Chinese government avoided large-scale monetary easing in 2020 to avoid the massive pent-up risk that inevitably occurs when unwinding becomes necessary.

The Chinese government bond market also does not look overvalued, as economic resilience to the pandemic and supply from special issuance of local government bonds have been nudging the bond market to trade softer in 2020, which should preempt the bond market from a big sell-off in 2021.

**Vivian:** The investment case for Chinese equities hasn't changed; instead, it is enhanced, because the transition to a domestic-consumption-driven economy has accelerated after COVID-19, which should further benefit the sectors in which we like to invest (including consumer, healthcare, and technology) and the companies we favor (leaders in those sectors).

We're also finding more quality growth ideas in the cyclical industries with structural growth drivers, such as smart infrastructure and green-energy-related industries, in light of the stimulus and government's increased support to technological advancement and self-independence.

**Clifford, where are you finding opportunities?**

**Clifford:** China's government bond market may surprise on the upside given that valuations do not appear to be overstretched, supply risk could come down, and offshore demand remains strong. With inflationary risk remaining low and food prices likely to normalize further in 2021, there are opportunities in long duration in the cash bond market and curve flattening trades in the derivatives market.

**Can the strength of the Chinese yuan renminbi (CNY) continue? Where is the line in the sand?**

**Clifford:** Assuming the U.S.-China relationship normalizes in 2021, growth returns to a medium-term trajectory of 5% to 6%, and offshore investors remain enthusiastic about allocations to Chinese equities and bonds, the CNY could further strengthen.

However, a strong currency does not always represent the best interests of the government and the economy (regarding export competitiveness, for example). Plus, with the risk of current accounts retreating back to borderline surplus and onshore diversification flows building up, the CNY may not have all the ingredients it requires for another strong year of outperformance. I think the best case is a strong resistance level of 6.35 to 6.40.

**What impact do you think the new U.S. administration will have on the China investment case?**

**Clifford:** At this point my best guess is no further escalation of what is the historically worst relationship between the two countries. But it will take time for both sides to reset the agenda. We should not expect the United States to immediately become reconciliatory given the bipartisan support to the existing approaches on both economic and political fronts.

**Vivian:** I agree with Clifford that the new U.S. administration does not fundamentally change the U.S. view of China as a strategic competitor. Conversely, the transition to a new U.S. administration should not alter the investment case for China, because China continues to shift to a domestic-consumption-driven economy and reduce its reliance on global trade and foreign technologies.

We should see more Chinese companies get better and bigger at a faster pace than before, exhibiting accelerated growth, improved returns, stronger management, and better ESG attributes.

From my perspective, this remains a key fundamental support for attractive investment opportunities in China. Perhaps on the margin, the new U.S. administration may lead to more structured and predictable policies toward China, which would benefit the investment case for China in the near term.

**What's your guess for how 2021 will play out in Chinese equities and debt?**

**Clifford:** For China's government bonds, my base-case guess would be a benign inflationary backdrop coupled with tailwind for the CNY supporting strong inflows from offshore investors, which would result in rates rallying.

**Vivian:** I expect earnings growth of Chinese companies—especially quality growth companies—to remain strong in 2021 if current consensus estimates for Chinese GDP growth take hold.

The biggest unknown is valuation, especially after two consecutive years of strong bull markets. My base-case prediction is that price-to-earnings (PE) ratios of the markets overall should remain steady at current levels in the mid-teens. With that, we could still see solid appreciation in equities.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