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China's Slowdown

China – China – China! Perhaps it should be India – India – India?

In any event, this is a good review of the '"customers" for non-North American companies. Enjoy the read. Comments or questions always welcome.

David Knight | Partner | Georgian Capital Partners
Scotia Plaza, 40 King Street West, Suite 3405 , Toronto, ON M5H 3Y2
Toronto: (416) 640-4100 | E-mail: dknight@georgiancapital.ca
www.georgiancapital.ca

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INVESTMENT OUTLOOK

September 2023

China's Slowdown

What is happening to China's economy and what will be the effects on the rest of the world? It is not easy to dissect the data, or even obtain accurate data, about China's economy, which is a very large continental economy similar to the USA. What we know is that there is a "balance sheet recession" among Chinese consumers due to a long period of uncertainty after two years of Covid lockdown, pessimism about the employment outlook, and most importantly the collapse of the property market. New home sales have fallen by 80% since 2020, and annual housing demand has fallen from a peak of 14 million to below 10 million. Given that property, housing, and infrastructure construction contributed almost 40% of China's growth during the boom years, there is a widespread impact.

Today, however, China's GDP is made up of 66% consumption and 34% business investment. The recent softness in retail sales, which only grew 2.5% in July, is an indicator of the caution on the part of Chinese shoppers. Exports are also weak, and as a result of US/China tensions and sanctions, have fallen 16% in the last year (There is one exception, which is ASEAN, where they have grown 15% in 2022). Our overall forecast is for China to grow at between 3% and 4%, but this projection is imperilled by the possible ramifications of a major debt default by Country Garden and the impact it might have on confidence and the banking system. For

LLOYD GEORGE MANAGEMENT (HK) LIMITED
UNIT 21 & 23 HOLLYWOOD BUSINESS CENTRE, 2/FL CASEY BUILDING
38 LOK KU ROAD, SHEUNG WAN, HONG KONG
TELEPHONE (852) 3468 7278
EMAIL: INFO@LLOYDGEORGEADVISORY.COM

the time being, we believe that the impact of China's property slowdown will be contained within its state-directed domestic economy, although there will be some impact on the demand for Australian iron ore, Chilean copper, and other raw materials. There is still strong growth in IT, healthcare, and energy. The Chinese stock market is selling on 11 times earnings and has already discounted this depressed outlook. On the other hand, it is likely that the Beijing government will take action to stimulate consumption, cut rates, lower the value of the Yuan, and boost animal spirits in the private sector. Alibaba, for example, is showing a 60% recovery in profits.

An additional, but important, point about China is that the Communist Party is not in the habit of providing bail-outs such as the US has done, for instance, in the case of Silicon Valley Bank. Xi Jing Ping has condemned Western modernization, saying that it pursues the interests of capitalists instead of the vast majority of people. He is focused on the challenge posed by China's large population, which is still only just 60% urbanized, leaving nearly 600 million people in the countryside who have not yet benefited from modernization. China's exports may well have peaked two years ago when they reached 15.7% of world exports. They have fallen sharply in the last two years, and China has also seen a collapse in foreign direct investment (FDI) by 87% to only US$4.9 billion in the second quarter of this year – the smallest quarterly amount since 1998. This clearly signals the reverse of globalization, of which China has been the biggest winner for the last 20 years since it joined the World Trade Organization.

On the other hand, the share of China's exports to the "global south," including Africa, Latin America, and Southern Asia, has grown nearly 30% in the past five years. Some of this must be due to the "One Belt One Road" policy of extending generous loans to these emerging countries who then employ Chinese engineering companies and buy Chinese-manufactured goods. Here too, we expect that the "One Belt One Road" policy will slow down, if not peter out, as a result of funding difficulties by the big Chinese banks. The Chinese government will keep the Renminbi weak, will lower interest rates as much as possible, and will support the state-owned banking system; but all of this may be "pushing on a string," as regards getting the Chinese consumer to spend, and getting the economy growing again.

Nearly all the markets that we follow now show 10-year bond yields higher than the equity yields available in stock markets – notably in Asia, South Korea, India, Hong Kong, Indonesia, and the Philippines. Finally, there is good news from Thailand, where, after a long period of hiatus, a new coalition government has been formed with a pro-growth economic policy, including Thaksin's old party, Pheu Thai. We expect a recovery of the Thai stock market, and we are also increasingly positive on the outlook for Vietnam, which is trading at 9 times next year's earnings with 34% profit growth expected. Vietnam has 100 million population, with a positive demographic profile, or 55% of the population under 35, an educated low-cost workforce, and an ideal location to benefit from relocation of manufacturing by companies in Japan, South Korea, and the USA out of China. Vietnam's average annual salary is about 40% of China's and half that of Thailand and Malaysia. The market was very weak in 2022, owing to local political and corruption problems; but we believe that this bear market has now ended and that we can see 50% upside in the Vietnam market, which will probably be upgraded from a Frontier to an Emerging Market.

So what is the impact on the wider world of China's slowdown? One big beneficiary is SE Asia, which has seen a rapid growth in trade with China and is the beneficiary of offshoring by international companies to cheaper labour sources, such as Vietnam, Indonesia, Bangladesh, and India (which has now become the #2 Apple supplier after China). We are, therefore, very positive on the outlook for stocks in Singapore and the SE Asian region, which we estimate will grow at close to 6%-7%. India is also having a good year with over $15.8 billion inflow of foreign portfolio investment. India's economy is growing at nearly 6%. The Rupee was weak at 83 vs US$ because of oil prices, and Prime Minister Modi has issued a ban on the export of rice because of shortages due to flooding. India's bank sector is the fastest growing in the world, with high profitability and low nonperforming loan ratios. On balance, we think that India's stock market is fairly valued at 22 times, roughly the same as the S&P 500 with a projected earnings growth of nearly 20% in the next year, compared to 5% in the USA.

Over the next year, we see oil prices rising to $120 a barrel, and the possibility of a second wave of inflation because of this, as well as food price rises. Some commentators liken the current situation to the 1970s with the peaks of inflation occurring in 1974/75, and again in 1978/79, driven by events in the Middle East with OPEC quadrupling oil prices after the October 1973 war with Israel, and then the fall of the Shah in December 1978, triggering a further rise in energy prices. This possibly accelerated cycle in the 2020s could have a political impact in next year's US election. Our sense is that there are a lot of unpredictable elements, including China's economic slowdown and the possible impact of Taiwan's presidential election in 2024 and the commodity price cycle. We have previously observed that the combination of growth in India and SE Asia is equal to the additional demand for energy and minerals that China demonstrated in the past 20 years.

On balance, we still find some good investment opportunities in selected sectors in China and expect a recovery in Chinese shares in the second half of this year, and continued strength in SE Asia and India. We particularly like I.T. and automation, energy, industrial equipment, solar, wind, and electric vehicles - all sectors supported by Chinese government policies.

Another interesting development is the BRICS conference in Johannesburg on August 22-24, with 60 nations attending. The new group, which includes Saudi Arabia, Iran, Argentina, Egypt and Ethiopia, has not, as expected, tried to launch a new BRICS currency. This indicates the political difficulties of persuading India, for example, to accept a gold-backed currency, which Russia and perhaps China, would like; but it does not suit the energy-importing nations. The advent of Saudi Arabia in the group may, however, shift the balance of power; and it certainly indicates a weakness in the US diplomatic position both in the Middle East and with the developing nations of the South, such as Brazil, South Africa, and India.

R. Lloyd George

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