

# GLOBAL PERSPECTIVES

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## CHINA'S GREAT REOPENING: OPPORTUNITIES AND RISKS

- ▶ China has ended its Covid restrictions with astonishing speed and the economy is already recovering rapidly. This major development presents both opportunities and risks for investors.
- ▶ Opportunities include stronger Asian growth and revenue gains for selected US firms with large sales to China. Chinese stocks should also benefit from rebounding earnings and valuations.
- ▶ Key risks are whether China's reopening will put upward pressure on global manufacturing goods prices or energy prices. Oil prices remained subdued for now but bear close watching.

HIGHLIGHTS

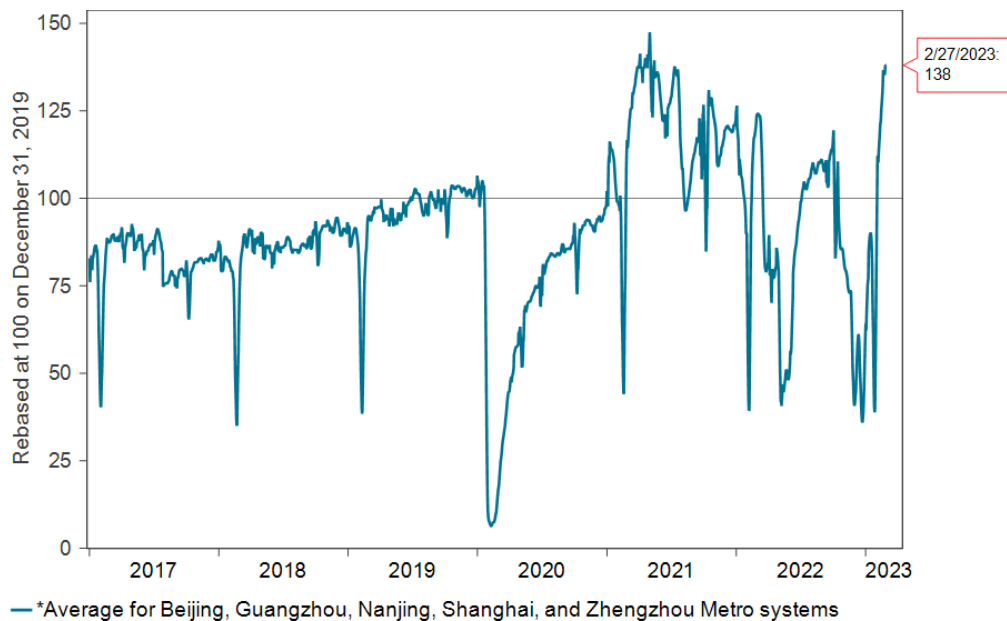
## CHINA'S REOPENING RECOVERY IS UNDERWAY

After nearly three years of rolling lockdowns, China has ended its Covid restrictions faster than any other country. In weeks, it has scrapped its main tracking app, ended harsh quarantine measures and criminal penalties, and welcomed foreign visitors without quarantine. The shift from zero-Covid to living with the virus is stark.

The economy has responded strongly. Mobility indicators have bounced back since early 2023 (**Figure 1**). Hotel occupancy during the Lunar New Year holiday returned to pre-pandemic levels, and hotel stays were more expensive. Compared to 2022, air travel increased by a third in January.

**FIGURE 1**

**China Subway Passenger Traffic Is Bouncing Back from December 2022 Lows (7-Day, 5-City Average\*)**



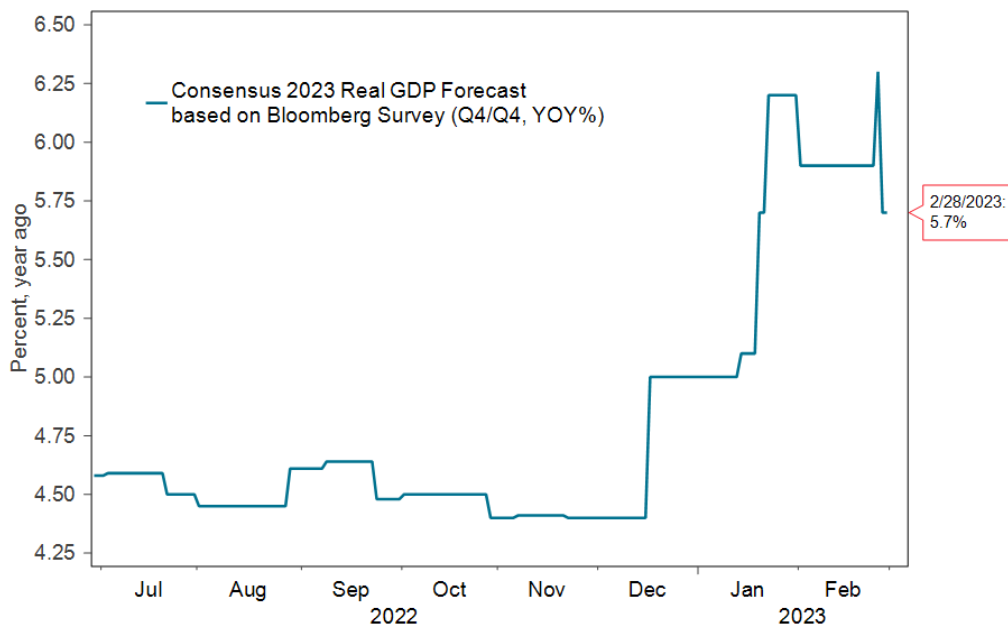
Sources: GW&K Investment Management and Macrobond

China's reopening recovery is reflected in high-frequency mobility indicators, like subway ridership in major cities, which was 38% higher than pre-Covid levels by the end of February.

Official data confirms the rapid recovery. The official Purchasing Managers Indexes for both January and February were much higher than expected. Notably, the February numbers for both manufacturing and services are among the strongest in a decade. Economists have upgraded their forecasts for China's GDP growth in 2023. Bloomberg's survey now expects a 5.7% year-on-year rate in the fourth quarter, up from 4.5% last September (**Figure 2**). The IMF has also raised its projection for China's growth in 2023 to 5.2%, from 4.4% in October.<sup>1</sup>

**FIGURE 2**

### China Growth Forecasts Have Ramped Up Since End of Zero Covid Policies



Sources: GW&K Investment Management, Bloomberg, and Macrobond

Factoring in reopening, economists have upgraded their forecasts for China's GDP growth. Bloomberg's survey now projects 5.7% Q4/Q4 real growth for 2023, up sharply from 4.5% last September.

China has lured foreign capital, as investors see a brighter outlook and seek exposure to its markets. The country's reopening is potentially one of the most important macroeconomic developments of 2023. As always, big economic developments can create both opportunities and risks for investors.

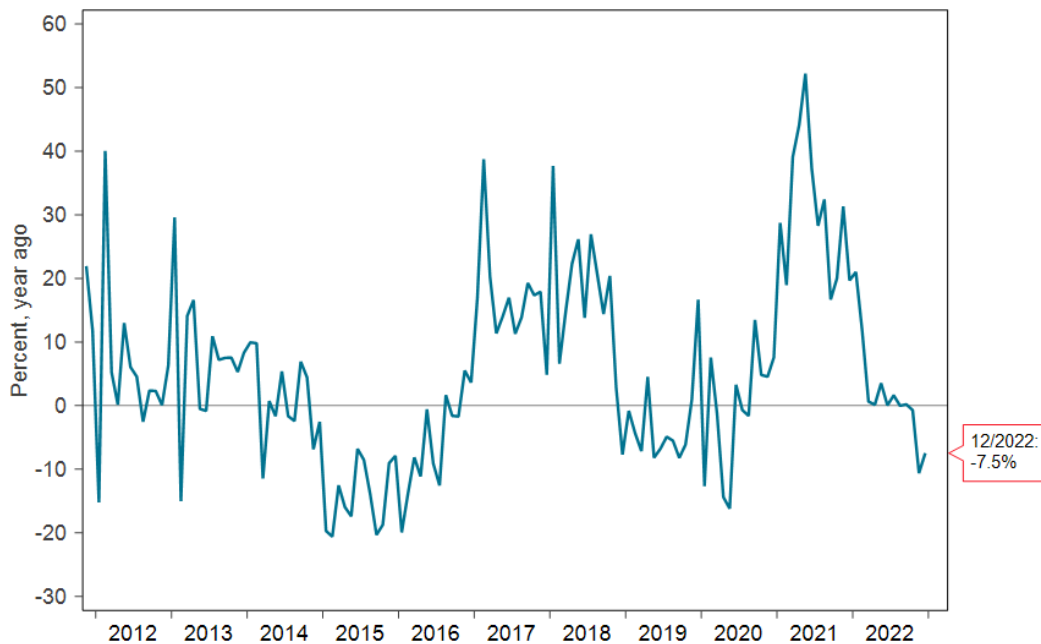
<sup>1</sup> Eric Martin, "IMF Eyes 'Turning Point' for World Economy as Growth Bottoms," Bloomberg News, January 31, 2023.

## OPPORTUNITIES: STRONGER ASIAN GROWTH AND REVENUE GAINS FOR SELECT US FIRMS

China's reopening will reshape Asia's economy. Its imports fell sharply because of Covid lockdowns that disrupted supply chains (**Figure 3**). We expect a rebound as restrictions are further relaxed and demand recovers. Vietnam, Taiwan, Malaysia, and Singapore will benefit most from this revival: they export consumer electronics, food products, textiles, and cosmetics to China worth 6% – 9% of their GDP.

**FIGURE 3**

**An Increase in Chinese Demand Should Boost Imports:  
China's Import Growth (USD, %YOY)**



Sources: GW&K Investment Management and Macrobond

China's import growth was negative in recent months, reflecting the weakness of China's economy in 2022 under rolling lockdowns. Reopening should boost imports substantially in coming quarters.

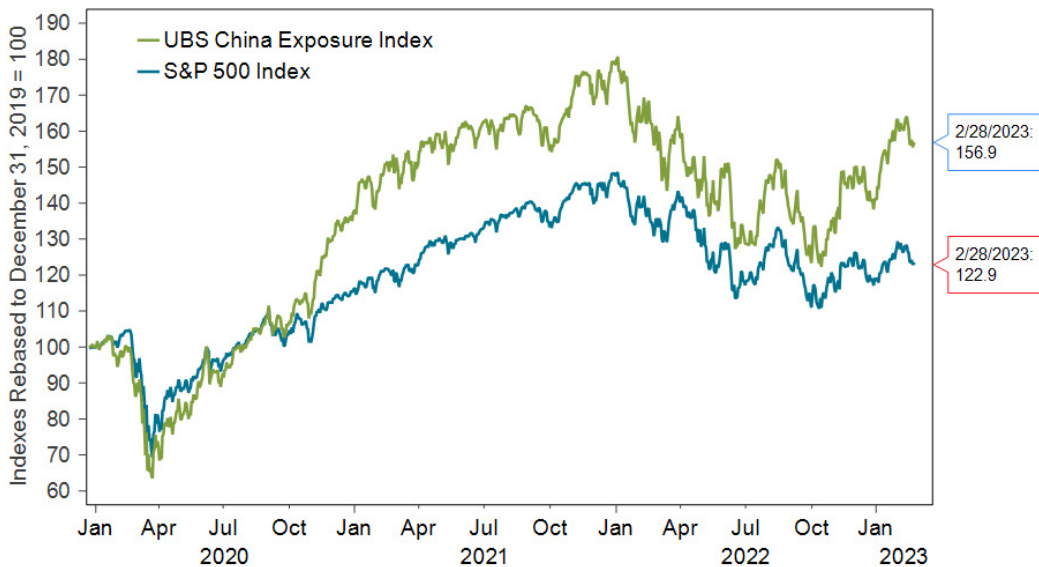
Tourism and education sectors in Asia outside of China will also likely feel a boost. Chinese tourists spent lavishly in Asia before the pandemic: In 2019 Chinese tourists accounted for 6% of Hong Kong's GDP, 3% of Thailand's and 1% of Singapore's. Thailand and Hong Kong will welcome them back eagerly, particularly in leisure and gaming. As will Singapore, which has a strong reputation for overseas education among Chinese students.

It should be noted that US exports to China account for less than 1% of America's GDP. But some American firms, such as Wynn Resorts, Apple, and Caterpillar, rely heavily on sales to China. These firms stand to gain from China's rebounding growth, to the extent rising trade and diplomatic tensions between the two countries don't create another hurdle.

Investors have lately rewarded such firms. The UBS China Exposure Basket, a group of 50 American stocks with large sales to China, has surged by 27% since last September — outpacing the 11% rise of the S&P 500 over the same period (**Figure 4**).

**FIGURE 4**

### US Stocks with China Exposure Have Outperformed the S&P 500 in Recent Years



Note: The UBS China Exposure basket tracks the performance of 50 US stocks in which China represents a large component of existing sales and is vital to expectation for future growth prospects.

Sources: GW&K Investment Management, Bloomberg, UBS, and Macrobond

A basket of US stocks with large exposure to China has outperformed the S&P 500 since the end of 2019 and is up by 27% since last September, more than double the 11% rise in the S&P 500 since then.

## OPPORTUNITIES: REBOUNING CHINESE EARNINGS AND VALUATIONS

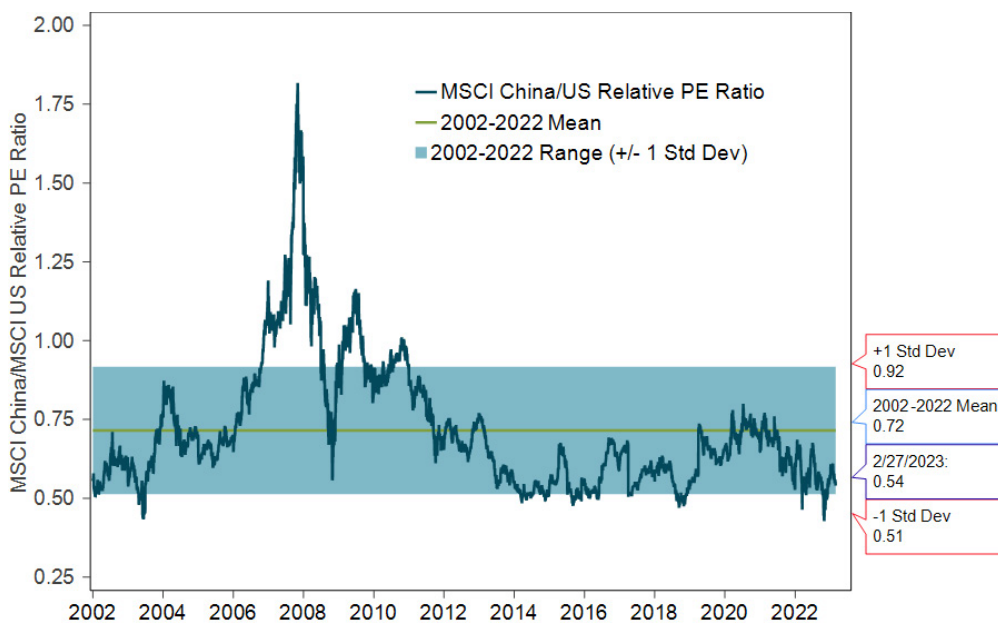
Foreign investors are returning to China's stock market. In January they bought a net \$21 billion worth of domestic shares, a record monthly high since 2017. The MSCI China Index, which tracks Chinese firms listed at home and abroad, has soared by 37% since October. The CSI 300 Index, which covers mainland-listed firms, has risen by 16% over the same period.

The rally has two main drivers: earnings and valuations. China's economy is recovering from the pandemic, boosting corporate profits. GW&K's Emerging Wealth Equity Portfolio Managers, Tom Masi and Nuno Fernandes expect net profit margins to bounce back smartly as demand picks up.<sup>2</sup> The net profit margin for the MSCI China Index recently fell to 8.2%, well below its two-decade average of 11.4%. That suggests ample room for profits to rebound along with the economy.

Meanwhile, Chinese stocks look cheap relative to US stocks. The MSCI China Index trades at 10.6 times its trailing earnings, a 46% discount to the MSCI USA Index (**Figure 5**). That gap is wider than the historical average of 28%. If Chinese firms can narrow their profitability gap with American ones, and if investors assign them higher valuations, Chinese stocks could deliver hefty returns.

**FIGURE 5**

### Chinese Stocks are Cheap vs US Stocks Based on the Relative Trailing P/E Ratio



Sources: GW&K Investment Management, Bloomberg, and Macrobond

MSCI China is trading at a trailing PE ratio of 10.6 times versus 19.9 times for MSCI US. That's a 46% discount on a relative PE basis compared to an average discount of 28% since 2002.

Tom and Nuno call attention to risks such as trade tensions, a Taiwan conflict, a property crisis, and government meddling.<sup>2</sup> But global equity investors seem wary of these risks. According to data from J.P. Morgan, emerging market (EM) equities make up only 6% out of their collective \$24.8 trillion in assets. This is well below EMs' 11.1% share of global market capitalization.<sup>3</sup> China, which represents roughly a third of the MSCI EM Index, suffers a \$400 billion underweight because of this. That degree of cautious positioning leaves room for optimism — if China can avoid major trouble.

<sup>2</sup> Tom Masi and Nuno Fernandes, "Considerable Upside Potential for China Equities Warrants Exposure," GW&K Investment Management, *Emerging Wealth Insights*, January 2023.

<sup>3</sup> Janik Mody, "EM Inflows Losing Steam, Active Inflows Sustain," EM Money Trail, J.P. Morgan Global Research, February 17, 2023.



A growing concern is that China aids Russia's invasion of Ukraine, which would trigger harsh sanctions from the US and Europe. Financial markets are apparently not too worried about that scenario given the outperformance of US stocks with China exposure noted above.

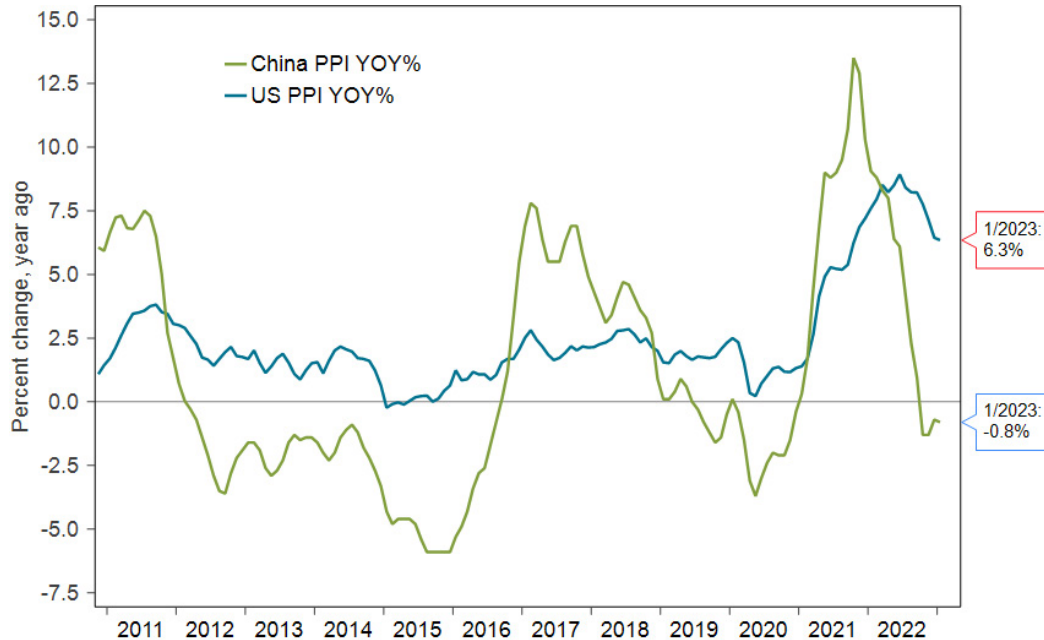
## RISKS: WILL CHINA EXPORT INFLATION?

As the world emerges from the Covid-19 pandemic, the persistence of inflation has become an increasingly prominent concern. One major question is whether China's post-Covid reopening will export inflation to the rest of the world. There are two main issues to consider.

The first is the potential impact on China's domestic inflation. China's manufacturing sector accounts for around 30% of global manufacturing, so any upstream pricing pressures in China could quickly be mirrored in other markets that depend on Chinese suppliers (**Figure 6**). However, there are several reasons to think that China's post-Covid reopening may not lead to significant inflationary pressures. China's PPI is currently declining about 1% year-on-year, and Bloomberg's survey of economists expects an increase of only 1.7% for 2023 overall.

FIGURE 6

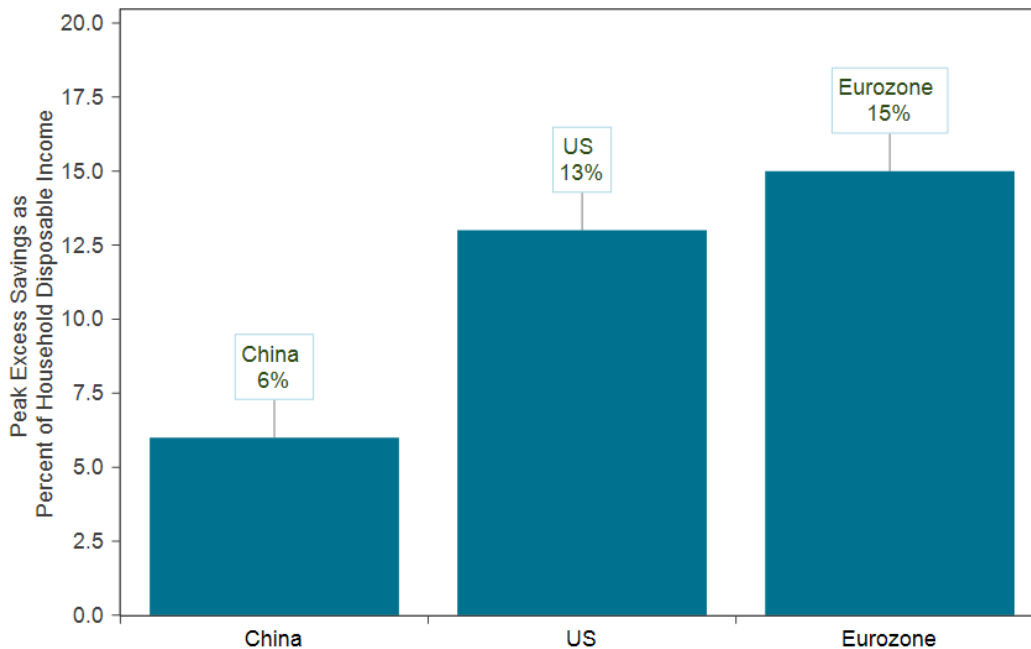
China's Producer Price Deflation Should End But a Repeat of 2021 – 2022 Double-Digit Inflation Is Unlikely



Sources: GW&K Investment Management and Macrobond

China's PPI deflation is likely to end, but the nation's moderate degree of economic stimulus should keep China's producer prices from spurring inflation elsewhere.

Moreover, the degree of excess savings in China that could trigger inflation is much more muted than in other major economies. Goldman Sachs estimates that China's excess savings are approximately 6% of household disposable income, compared to peaks of 13% and 15% respectively in the US and the Eurozone during the pandemic, due to more generous fiscal transfers to households and businesses in those latter areas **(Figure 7)**.

**FIGURE 7****China's Relatively Low Excess Savings:  
Percent of Household Disposable Income**

Sources: GW&K Investment Management, Goldman Sachs, and Macrobond

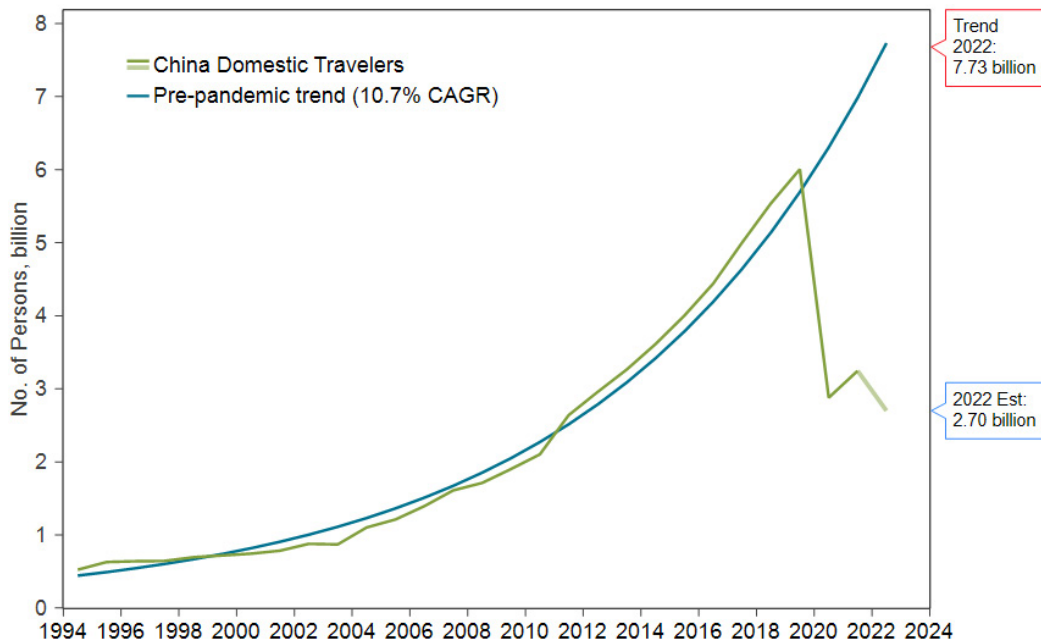
Due to less generous fiscal stimulus, the magnitude of China's pandemic-related peak excess savings is modest relative to other major economies. That should help restrain inflation pressure unleashed by the recovery.



The second major issue is the potential impact of China's reopening on global energy prices. With domestic travel still 65% below pre-pandemic levels, there is ample room for recovery as consumer behavior normalizes (**Figure 8**). Additionally, China's oil imports were 21% below their pre-pandemic trend at the end of 2022, suggesting the potential for a snapback in demand.

**FIGURE 8**

**Ample Room to Recover: China's Domestic Travel Fell in 2022 to 65% Below its Pre-Pandemic Trend**



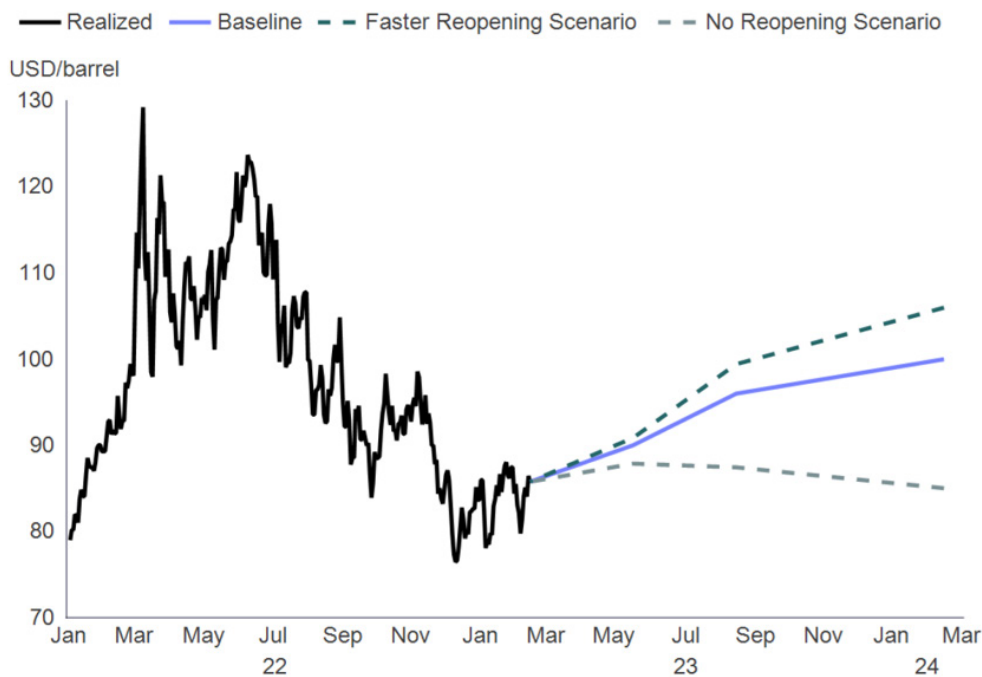
Sources: GW&K Investment Management and Macrobond

Nearly three years of rolling lockdowns pushed China's domestic travel to 65% below its pre-pandemic trend in 2022, leaving ample room for a snap back in both travel and related energy consumption.

The International Energy Agency (IEA) forecasts that China's reopening could boost global oil demand by 2 million barrels per day in 2023 versus the prior year.<sup>4</sup> As a result, the IEA raised its global oil demand forecast for 2023 to 101.9 million barrels per day. However, some energy experts predict considerably more upside for oil prices due to China's rebound (**Figure 9**).

**FIGURE 9**

**Brent Oil Price**



Sources: Macrobond, Goldman Sachs Investment Research Global Economics, as of February 2, 2023

Futures markets are projecting flat oil prices over the next 12 months, but energy analysts at Goldman Sachs believe that China's reopening will push the price of Brent crude oil back above \$100/barrel.

<sup>4</sup> Grant Smith, "IEA Boosts Global Demand Forecast as China's Economy Reopens," Bloomberg News, February 15, 2023.

Futures markets imply Brent crude oil will end the year at \$80 a barrel. If upward pressure on energy prices materializes, it could be a complicating factor for major developed market central banks who have prioritized fighting inflation. Nevertheless, the evidence suggests that the risks of inflation from China's post-Covid reopening may be more muted than some have feared.

Ultimately, the development of recessions in the US and Eurozone in response to tight monetary policy will heavily influence global energy prices. This may offset the impact of China's recovery. Regardless, China's reopening marks a critical milestone in the global economy's return to normalcy after the pandemic.



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