

China has been at the forefront of global events over the last twenty years, mostly for laudable developments, but more recently for concerning ones. As a result, China finds itself at a critical crossroad. The country surpassed Japan around 2010 to become the second largest economy by GDP. Over the ensuing decade, China experienced an impressive growth spurt that moved millions of people out of poverty and vaulted the country to become arbiter of global commodity prices, the standard for efficient, low-cost manufacturing, and a highly desirable market to penetrate. China's global economic presence provided a huge boost to world GDP contributing nearly 40% of the growth over the last decade.

After an admirable period of expansion, social development, and economic integration, China's leaders began to impose more rules and restrictions on certain industries or groups that impinged on operating freedom. Tech entrepreneurs were admonished or removed, homebuilders were reigned in, demonstrators in Hong Kong were jailed, and geopolitical rhetoric became confrontational and bellicose. While some actions may have been in response to statements from other nations, the thrust of policy was toward increased control, more government directives, restrictions on foreign investment, and reduced freedom. In addition, China's Covid experience exposed deficiencies in the country's healthcare system with consequences for citizens' perception of their government's concern for social wellbeing.

More recently, China's foreign policy decisions have raised consternation among western governments and spooked foreign investors. China's embrace of Russia, its enhanced military presence around Taiwan, and their visible opposition to western nation efforts on global disarmament, raised the specter of further alienating investors and other nations. Given the country's size and influence, we believe it is essential to assess China's likely evolution and the benefits/risks engagement with it likely entail.

Brief Review of Economic History

China's 20th century economic history traces its roots to the Chinese Communist Party's (CCP) assuming control of the mainland in 1949 under Mao Zedong's leadership. Mao attempted to move the country forward with a centrally managed industrialization and land redistribution policy termed the Great Leap Forward. Sadly, Mao's brutality and the CCP's inability to make peasants highly productive led to millions of deaths and limited economic advancement. After Mao's death, Deng Xiaoping took power, loosened government control over people's lives and launched economic reforms that effectively promoted an open market economy. Deng's policies were endorsed by leaders who followed him, and China's growth became explosive by the late 1980s.

It is important to mention that despite the promotion of economic freedoms, social restraint was ingrained in the CCP's policies leading to many disturbing events like the Tiananmen Square massacre and the Uighur genocide. In an apparent contradiction, an authoritarian controlled populace enjoyed the economic freedom to build wealth. From a purely economic perspective, this odd dynamism lifted millions out of poverty and made many individuals billionaires.

Current leader Xi Jinping took power in 2013 and has consolidated his rule over the last decade. Early in his leadership, he accepted the economic model, but launched a vast anti-corruption crackdown that entrapped many government officials and private sector executives. The cull also eliminated potential challenges to Xi's authority. More recently, under the auspices of "common prosperity," he began to centralize control of many industries and economic programs. Xi's actions display elements of the strategy used by Mao as he consolidated power and directed the economy.

Chinese economic growth slowed meaningfully after an initial burst following the severe Covid-driven lockdowns. China's strategic property sector, which accounts for about 30% of GDP, experienced multiple defaults after government interference tightened credit and diminished consumer confidence, soured sales. Also, future growth prospects are clouded by high indebtedness at banks and regional governments which limits the likelihood of large-scale stimulus.

Geopolitics

From the early days of CCP control, Chinese leaders emphasized military strength. The country began to flex its muscles demonstrating military might in the 1960s and became a permanent member of the United Nations security council in 1971. Despite joining global organizations that promote development like the World Trade Organization, China frequently voted against the United States on many issues, particularly related to mistreatment of people, unfair elections, weapons development and other issues that might make China's own actions on those matters questioned.

China repeatedly objected to sanctions against countries like Iran, Russia, Venezuela, and others and has actively supported authoritarian regimes with both enhanced commerce and monetary aid. While a neutral posture toward another nation's governing structure may be understandable, the apparent disregard for human suffering makes it hard for western nations and investors to support the regime.

Demographics

China is the largest nation by population at approximately 1.4 billion people. However, despite the large number of people, the country faces a significant demographic challenge. In 1979, China implemented a "one child" policy to slow its population growth. While this policy was relaxed in later years and eliminated in 2021, the country's birth rate has not risen enough to stem the population's aging trend and mortality rate. In fact, demographers believe China's population has begun to decline.

The implications of an aging population include the erosion of productivity and the deployment of resources toward the elderly. Less obvious for a country attempting to shift from a low-cost manufacturing exporter to a consumer driven higher value economy are the size and growth rate of that portion of the economy. Recently, China announced its youth unemployment reached a record 21.3%, enough for them to discontinue publishing the statistic. Of significance, China succeeded in educating many more of its citizens, but the growth rate in available jobs for this population cohort did not keep up. This group will soon become the prime parent aged cohort that will not likely reproduce if its economic prospects are bleak.

Implications

China faces many challenges ahead and, unfortunately, the current policy direction seems to be inadequate to put the country on a path to continue its impressive twenty-year expansion. The country's gradual encroachment on both individual and business freedom likely assures a deterioration in productivity. Recent growth underperformed expectations, nominally due to consumer caution after a rigid Covid-related lockdown. However, the reopening occurred after residents had been treated harshly, the housing crisis deteriorated with limited support for builders and home buyers, Xi Jinping visibly cozied up to Russia, and the young had no work.



For investors, China's path remains a quandary. Owners of Russian assets lost everything after that country invaded Ukraine. Investors in Iran and Venezuela have no recourse and likely hold valueless claims. While China may be deemed to be different, what happens if it invades Taiwan? So far, U.S. sanctions against China have been limited to government owned military-related manufacturers. An expansion of those may trap holders of even private sector companies.

China has had many ups and downs over the last few decades. A consistent feature, though, has been the country's growth trajectory and nominal social stability. It is impossible to forecast either economic decline or insurgency but, on its current path, we do not believe either outcome can be ruled out. Economists remain keenly focused on a possible recession in the U.S. and its implications for the global economy. We would not be surprised if the next big challenge for the world emanates in China.

October 15, 2023

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