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Why China's COVID Comeback Is Still In The Early Innings, With Upside Ahead

By Drew Bernstein

When you unshackle 1.4 billion consumers who have been penned up at home for three years, it's reasonable to expect some fireworks.

For the residents of Mainland China, life under "zero COVID" policies was a dreary round of rolling travel restrictions and lockdowns – as if the United States was permanently stuck on a skipping record of the Spring of 2020. While most of the population was able to find a way to get back to work eventually, the everyday routines of travel, dining out, and visiting friends and family were severely curtailed. Wallets stayed snapped shut.

Since China executed its "COVID pivot" in late December 2022, economists have been scrutinizing the data to see if the country will be able to achieve its goal of 5% growth in 2023. If achieved, China will serve as an engine to help developed economies avoid tipping into recession. This is particularly relevant in the new era of higher interest rates, shrinking money supply, and rolling banking jitters.

Initial government data for the first two months provided some early hints. China's retail sales jumped by 3.5% in January and February of 2023 after a decline of 1.8% last December. Spending on catering leaped by 9.2% after dropping by 14.1% in December. Clearly, Chinese consumers are beginning to find their footing. China has also indicated the need to expand domestic demand and prioritize expansion of consumption.

The Chinese government appears to be turning on the taps of fiscal stimulus, with infrastructure investment surging by 9% during the first two months this year. However, property buyers mostly stayed on the sidelines, with investment dropping by 5.7%. This raises the question of how long the government coffers can float the economy, given that the finances of so many local entities are already stressed from the burdens of financing years of COVID containment amid declining revenues from property sales.

Further, China's fabled export machine appears to be still stuck in the mud. Exports slid by 6.8% by January and February, and imports were down by 10.2% in the same period, missing analysts' estimates by a country mile. The hopes of Australian raw materials producers and German machinery manufacturers' that China will enable them to dodge a downturn may be a mirage.

A Generation at Risk

The statistic that should catch the authorities' attention is youth unemployment, which remained stubbornly high at 18.1% for those aged 16 to 24 in February. These young people are the most educated and invested generation in China's history, with nearly 58% of Chinese enrolling in tertiary education in 2021, up from just 12.5% in 2000 and 3.4% in 1990. These are the children whose parents have sacrificed everything to lift them to the next rung on the ladder of educational attainment and financial security. Now many are "lying flat" or sidelined by a lack of jobs.

If China is to leap into a technologically advanced, wealthy society, it must allow this generation to recognize its full productive and economic potential. Because if this cohort of talent is squandered, China indeed risks "getting old before it gets rich."

China has an opportunity to build a more sustainable, balanced economic model that policymakers have recognized as desirable for over a decade.

- Reopening – While China has lifted most of the formal travel obstacles, tremendous logistical friction remains. Airliners must be removed from mothballs, and routes to popular overseas destinations restored. After three years, China just announced that it would begin issuing tourist visas to U.S. citizens on March 15th. Hong Kong fully reopened to Mainland China in February 2023. Before this, even American CEOs have had to wait a month or more to visit their operations in the PRC, inhibiting their understanding of conditions on the ground and willingness to invest in growth. Chinese citizens wishing to visit Hong Kong or travel overseas must compete for a limited supply of visas. More important than the flow of tourists, China has now lifted the travel restrictions on Chinese students studying overseas, which peaked at more than 700,000 students in 2019 but has subsequently dropped by half. The U.S. government has also played a role in discouraging the flow through sometimes baseless harassment of students and scholars in STEM fields. If China truly wishes to grow into a global leadership position in the coming decades, it will need a generation that can understand and negotiate various cultural, political, and business environments. Today, the post-COVID youth generation – the so-called "Generation N" - is reported to be both pessimistic and isolated and more nationalistic than their predecessors. Optimism is essential to embracing careers, starting families, and launching new businesses – all ingredients China desperately needs.

- Rebalancing – For the past decade, Chinese policymakers have explicitly acknowledged that the asset-intensive growth model driven by speculative real estate development and infrastructure investment is inherently unstable. Capital investment rose from 24% of GDP in 1990 to 45% in 2013 and has remained in the low- to mid-40% range ever since. There has been increased recognition that much of this investment has gone toward piling up non-productive investment that increases the debt stock without producing economic returns. President Xi Jinping announced as much when he wrote that China

needs “to shift focus to improving the quality and returns of economic growth, to promoting sustained and healthy development rather than inflated GDP growth.” Yet whenever the government has moved to restrain the non-productive, highly leveraged real estate sector, it has backed off for fear of instability. As economist Michael Pettis has pointed out, China’s household consumption accounts for less than 40% of GDP. Combined with 10 to 15% of government consumption, China has the lowest consumption share of any economy in the world. Coming out of the COVID era, the Chinese government can now act boldly to rebalance the economy toward private consumption, services, and internal demand. This will require putting in place more robust systems of social and health insurance to reduce China’s outsized savings rate, continuing to support robust capital markets that funnel savings towards productive enterprises, and creating incentives for family formation that make it feasible to raise more than one child in an ultra-competitive educational system.

- Rallying the Private Sector – The undeniable economic miracle that took place in China had two central pillars. First, a state sector that prioritized economic growth and provided world-class infrastructure and a trained, plentiful workforce has proved irresistible to multinationals seeking to become more competitive in a globalizing world. Second, China made a very conscious decision to unleash the entrepreneurial energies of its people by destigmatizing the accumulation of wealth and promoting domestic champions through various implicit and explicit means. According to Harvard’s Kennedy School, China’s private sector contributes to 60% of China’s GDP but 70% of innovation, 80% of urban employment, and 90% of new jobs. Put another way, a bright future for China’s young college graduates is intrinsically tied to a vibrant private sector economy. Unfortunately, the combination of economic dampening during COVID and the drive to reign in the economic influence of China’s private technology sector has diminished the private sector’s expansion and business confidence. For the first time since the beginning of the reform era, the private sector’s share of employment and market value dropped significantly in 2020 and 2021. In recent weeks, Xi Jinping has been quoted in state media about the vital role of the private sector in economic development, saying on March 7th that “We should improve the development environment for private enterprises, remove the institutional obstacles that prevent them from fairly participating in market competition, and safeguard the property rights of private enterprises and the rights and the interests of private entrepreneurs according to law. We should… support the development of the private sector and the growth of private enterprises and boost market expectations and confidence.” If the government follows these warm words with consistent and predictable actions, the animal spirits of a revived private sector will provide a powerful “third leg” to the post-COVID snapback.

The markets appear confused about what to make of China’s COVID comeback prospects. After an explosive 55% rally between November and late January to 22,688 points, Hong Kong’s Hang Seng Index has retraced about half of its gains. The word on the street is that no buyer wanted to get steamrolled by the COVID reopening train, but they were not “conviction owners” of the rally.

Investors will likely have the chance to dip their toes back into Chinese equities in the second half of 2023. Based on market activity, we expect many China tech names to seek to launch overseas IPOs, particularly via the SPAC vehicle. Of note, beginning on March 31st, China's securities regulator, the CSRC, will, for the first time, implement a system for reviewing and approving overseas listings. Although this presents an additional hurdle to clear, it means that these issuers will have the government's imprimatur as appropriate for foreign ownership – removing one major risk factor for those who want to play the China comeback.

The Chinese government has also shown a tremendous talent for keeping equity investors on their toes, if not to say tearing out their hair. But if we begin to see the consistent implementation of the three "Policy Rs" outlined above, it would be foolish to bet against the vast, untapped commercial energies and appetite for a better life of China's 1.4 billion people.

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