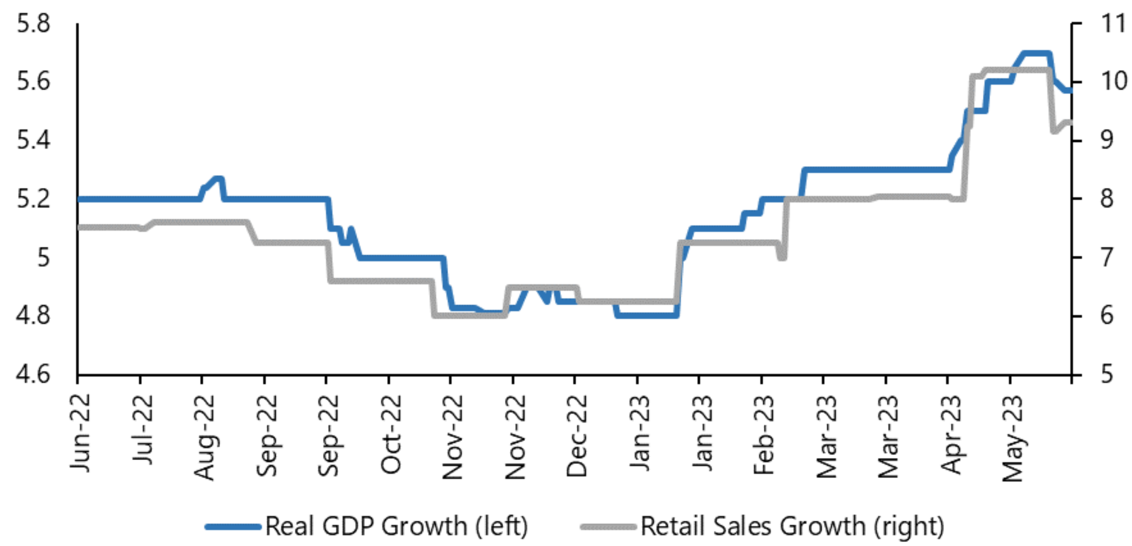
June 2023

Don’t Get Burned in China Again

We have avoided heavy exposure to China, and the more loudly sell side analysts talk up China’s economic prospects, the more convinced we are that this caution is well advised. Never in our experience has the disconnect between Wall Street bullishness and China’s bearish reality been more glaring. Analysts keep calling for 2023 GDP growth to come in well above 5 percent—higher than the official growth target—and for retail sales to grow at 9 percent. But company reports suggest growth that fast is not possible.

The consensus is even more optimistic than the official target

Chart 1. 2023 China consensus forecasts: GDP and retail sales
(Percent)



Source: Bloomberg Forecasts, Breakout Calculations.

When forecasts clash with facts, what do you do?

If China’s economy were growing in the 5 percent range, then based on our calculations from historical trends, corporate revenues should be growing faster than 8 percent. Instead, in the first quarter, revenues grew at 1.5 percent (see chart below). As GDP and retail sales forecasts rose, corporate revenue growth fell.

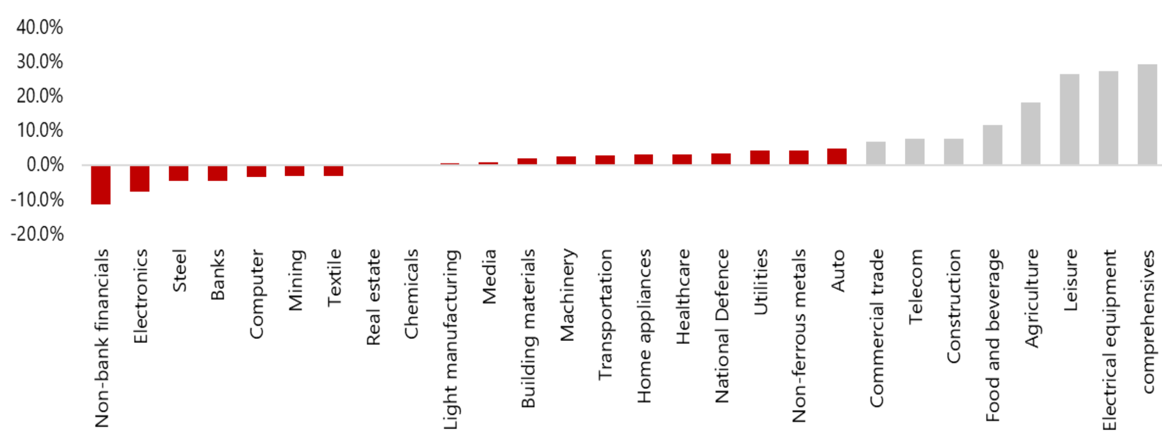
Chart 2. Revenue growth for China and earnings growth in consumer companies is tailing off, not shifting upward (Percent)

Source: UBS, Wind. Note: Y-Axis is truncated to eliminate the extreme growth values Note: Consumer sector earnings growth of -1% in Q1 2023 – based on the data from UBS; Historically there is a correlation of almost 80% b/w this and the GDP growth

If the economy is so hot, why are so many sectors so cold?

We suspect that many economists, having hyped prospects for a 2023 reopening boom in China, are now reluctant to reverse themselves, no matter the evidence. Hopes for a reopening boom were built on the premise that Chinese consumers, released from lockdown, would go on a spending spree, and that simply hasn't panned out. Corporate revenues normally grow faster than GDP, but now they are growing slower than officially stated GDP in 20 of China's 28 sectors, including consumer sectors from autos to home appliances and computers (Chart 3 below)

Chart 3. Revenue growth for different sub-sectors in Q1 2023
(Percent; Sectors shown in red are growing slower than the official GDP growth)



Source: UBS, Wind

Chinese consumers are not seeking “revenge”

Depressed revenue growth is stalling earnings for consumer companies (Chart 2 above, blue line). Normally, consumer sector earnings track GDP growth closely (the correlation is 80 percent), but they have been falling steadily and turned negative in the first quarter. If Chinese consumers were engaged in “revenge spending,” the opposite trends should be unfolding.

Contradictions in the official data

Wall Street’s call for plus-5 percent growth in China is contradicted not only by company reports, but also by official reports showing serious weakness in everything from industrial output to retail sales. If the sell side analysts were right, and consumer demand were picking up in a strong economy, imports would be strong. Instead imports fell 8 percent in April. Forecasters expected China’s credit volume to expand by 1400 billion RMB in April, yet when it came in half that strong, few if any saw fit to rethink their GDP numbers. Instead, they dismissed the mounting evidence of economic weakness as a hiccup, or a seasonal adjustment, as if spring had come unexpectedly this year.

Chart 4. Key economic releases over the last month

Economic Indicator	Period	Consensus Estimate	Actual Data
Industrial Production YoY	April	10.9%	5.6%
Retail Sales YoY	April	21.9%	18.4%
New Yuan Loans	April	1400 bn	719 bn
Manufacturing PMI	May	49.5	48.8
Non-Manufacturing PMI	May	55.2	54.5
Exports YoY	May	-1.8%	-7.5%
Trade Balance USD	May	95 bn	66 bn
CPI YoY	May	0.2%	0.2%
PPI YoY	May	-4.3%	-4.6%

Source: Bloomberg, National Sources, Breakout Capital Calculations

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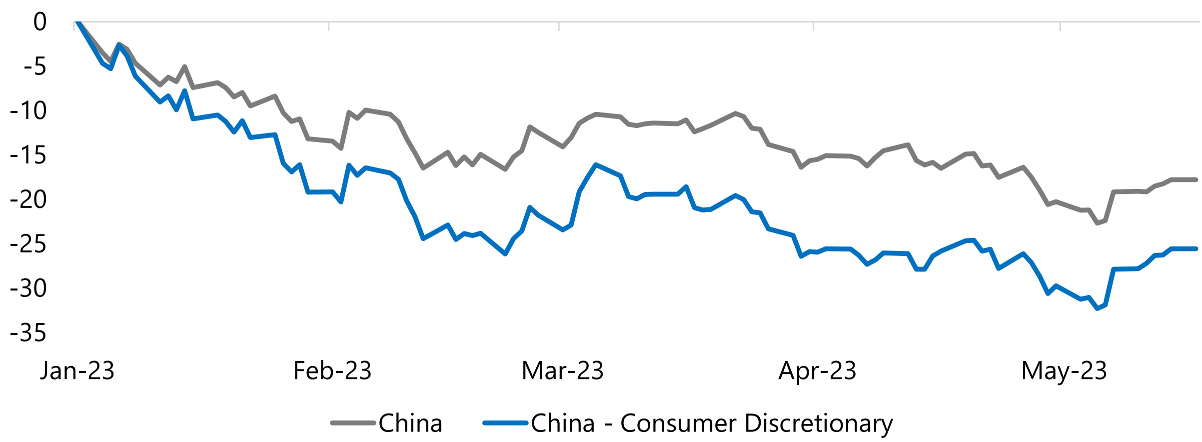
Why the gap between forecasts and reality is so big now

As a result of declining population and productivity growth, China's potential GDP growth is now half the official target, closer to 2.5 percent than 5 percent, in our view. Over the last decade China has managed to slow the inevitable deceleration in its economy through massive stimulus and debt, but that campaign is now running out of steam. While Wall Street analysts have long been reluctant to risk their business interests in China by questioning official growth targets, their reluctance may be particularly acute now, after all the rosy forecasts for a reopening boom.

Unfortunately, investors who listened to those forecasts have already been burned. Instead of a reopening rush, the MSCI China stock index has fallen 18 percent and consumer discretionary stocks are down 26 percent from the January peak. The decline in market cap translates into losses in the range of $600 billion. Our advice: don't get burned again.

Chart 5. As GDP forecasts went up, the stock market went down

MSCI China in grey, consumer discretionary in blue; shows cumulative returns from January peak



Source: Bloomberg, Breakout Capital Calculations

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