On the Minds of Investors

Marking the bottom of the Chinese economic cycle

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In brief

- Following the full relaxation of pandemic control measures in China in November, official data and big data analysis suggest that Covid infections may have peaked in the major cities as early as late December.
- With economic activity now rebounding quickly, we expect sustained growth momentum in the coming months to support investor sentiment and market performance.
- For investors in Chinese equities, the initial beneficiaries will likely be those companies that are most sensitive to the reopening, such as in services and consumer-related sectors. We may also see renewed support for technology stocks, and expect to see an eventual rotation back to longer-term economic restructuring themes as sentiment recovers.

Since late November, China has dramatically shifted from a stringent zero-Covid policy towards full-scale reopening. The rapid removal of mobility restrictions has caused Omicron infections to spread across the country. A month and a half into reopening, however, evidence suggests most provinces and cities have now passed the first wave of infections, and economic activity looks to be recovering, based on high frequency transportation data.

Covid infections look to have peaked

Assessing the spread of Covid in China is difficult given the lack of official data on infections. The only official data was released by Henan Province, which announced that 89% of its population had been infected as of 9 January. Given the size of Henan province (it is the third most populous province in China) these infection numbers might be representative of the nationwide trend after reopening.

We can also look to track infections using various big data tools. For example, key word search indices from Baidu, a search engine, suggest that Covid infections may have peaked in major cities in late December (**Exhibit 1**). Using big data analytics and questionnaire surveys, a research team from Beijing University has also claimed that infections peaked in most regions before 20 December 2022, estimating that 900 million (or 64%) of the Chinese population had been infected, as of 11 January.

However, while the peak in this Covid wave appears to have passed, the high likelihood of repeat infection waves in the future means that continued efforts are required to improve vaccination rates, particularly among older people.

Exhibit 1: Baidu pandemic search index

Million

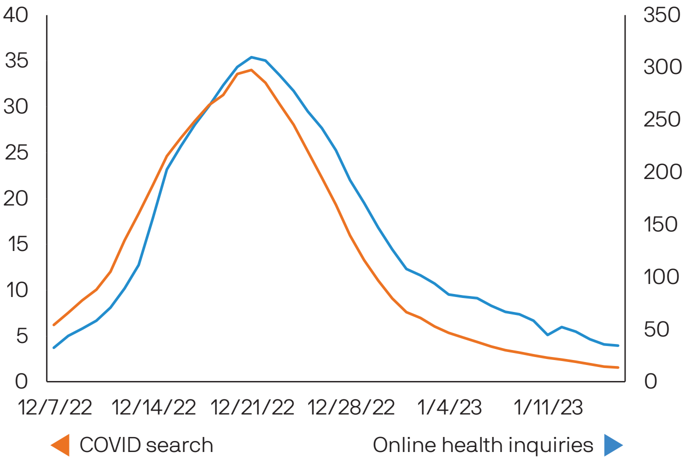
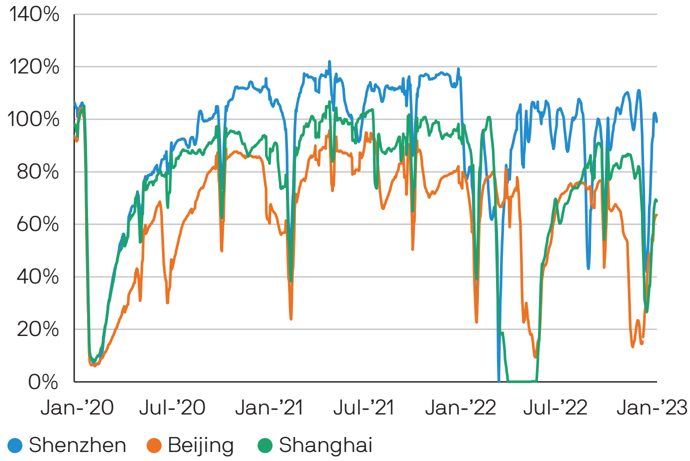


Exhibit 2: China major cities subway passenger flow

Index, 2019 average as 100, 7-day moving average



Source: J.P. Morgan Asset Management; (Left) Baidu; (Right) Wind, Local subway companies. Data as of 01/17/2023.

Economic activity may be bottoming out

The economic outlook is brightening. Big data analysis points to the low severity of the Omicron strain, suggesting that economic activity could normalise quite quickly after the first wave of infections. Economic data also points to a broad economic rebound, with mobility indices, such as subway flows (**Exhibit 2**), urban traffic congestion and freight transportation, all now either at, or close to, their pre-pandemic levels.

The Chinese economy had decelerated through the last quarter of 2022, dragged down by the zero-Covid policy in October and November, and then hit by the pickup in Covid infections in December after restrictions were lifted. Real GDP growth declined to 2.9% year on year (y/y) in the fourth quarter (compared to 3.9% in the third quarter) according to the Chinese National Bureau of Statistics.

In December 2022, with so many people infected and staying at home, retail sales decreased 1.8% y/y, with the food services sector slumping 14.1%. Meanwhile, industrial production, dragged down by labour shortages, grew just 1.3% y/y in December, down from 2.2% in November. Thanks to the government's infrastructure investment push and monetary easing, fixed asset investment remained relatively stable at 3.1% y/y.

Despite this weakness, December 2022 may turn out to have been the low point for Chinese GDP growth, at least in the near term. High-frequency indicators are pointing to a quick recovery in economic activity as the peak in infections passes across the country. By mid January, subway passenger flows had recovered 60%-70% relative to pre-Covid levels in Beijing and Shanghai, and even exceeded the pre-Covid level in Shenzhen.

We expect to see a sustained economic recovery in 2023, as a result of the reopening and policy stimulus. Service sectors should be among the early beneficiaries, as pent-up demand is released. Sales of consumer goods might also pick up due to improving confidence and continued policy support.

On the other hand, risks persist in the property sector, which requires further credit support, and in local government debt. Accommodative policies should also remain in place to support business confidence. Hence, an additional interest rate cut is expected in the first quarter, followed by the extension of liquidity facilities by the People's Bank of China.

Investment implications

Since November 2022, expectations for reopening have driven investor inflows in both the China onshore and Hong Kong markets. Consumption, and other sectors most sensitive to the economic reopening, have been the key beneficiaries. Meanwhile, softer regulatory measures and steady progress on US audits of Chinese technology companies listed in the US have provided additional support to offshore technology names.

The economic uptrend is likely to be sustained after the Lunar New Year holiday, albeit with a potential sector rotation. Once the expectation for a recovery in consumption is priced in, investors might rotate back to long-term themes, such as the green economy and the growth of advanced manufacturing sectors. These strategic sectors will play an important role in the long-run restructuring of China's economy and will also benefit from an increasingly friendly policy environment.

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