Allianz Global Investors

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Will China's economy regain its roar in the Year of the Dragon?

As East Asia celebrates the Lunar New Year on 10 February 2024, investors in Chinese equities will be relieved to bid farewell to the disappointing Year of the Rabbit, and may wonder whether the Year of the Dragon – traditionally considered one of the luckiest in the Chinese zodiac – will live up to its reputation. Yet, neither astrologic wisdom nor a fatalistic extrapolation of the recent past will be good guides for investors. As always, analysing the prospects of China's equity markets requires a clear and dispassionate look at the key factors pivotal for their success. Indeed, while China's structural problems are very real, viewing the current bout of economic weakness as the new status quo is likely to be as misguided as the unbridled optimism of just three years ago.

So, what are these key factors that will be pivotal in 2024?

First, the extent of fiscal and monetary stimulus the Chinese government is willing to deploy – and the manner in which it deploys it – will be closely watched. Premier Li Qiang's speech at Davos, comparing the Chinese economy to a healthy person with a strong immune system, and highlighting that last year's growth had been achieved "without resorting to massive stimulus", has led equity markets to question whether more support is in the pipeline. We continue to believe, however, that the government will have little choice in extending support, even while it remains cautious not to significantly expand its debt burden. Indeed, policy makers will endeavour to meet China's 2024 GDP growth target – expected to be around 4.5-5% - and additional stimulus may be unavoidable to facilitate this.

In an additional sign of a potentially shifting government response to China's economic challenges, the People's Bank of China (PBoC) announced that it would lower the reserve requirement ratio (RRR) – the proportion of liabilities

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that banks must hang on to, rather than lend out or invest – by 50bps, effective from 5 February. PBoC Governor Pan Gongsheng also confirmed further supporting measures for the agricultural sector and small and medium-sized enterprises. Also welcomed was the joint announcement by the PBoC and the National Administration of Financial Regulation of measures to improve the scope of fund use and liquidity for property developers. This points to establishing a more coherent framework for managing the restructuring of the property sector – an essential part of China's recovery story. We expect this will be a complex, multi-year process.

Second, market valuations are at depressed levels. The MSCI China A Onshore Index is trading close to 11x forward PE, well below its long-term average.[1] Much of the China equity market decline seen over the past year is due to derating, as opposed to weaker corporate earnings. To a large extent, this derating reflects both the higher risk premium placed on the asset class, as well as a loss of confidence across domestic and global investors. For the market to recover, an important first step will be restoring this investor confidence.

Signs of improvements in China's economic outlook will be crucial for taking this step. An uptick in domestic consumption – potentially helped by a spike in "dragon babies" born in this auspicious year – could be just such a sign. While numbers remain subdued, the queues to acquire a Lots-o'-Huggin' Bear (the fluffy villain from Pixar's Toy Story 3) at the recent opening of a CostCo in Shenzhen, and the social media frenzy the five-foot bear generated, may offer anecdotal evidence that the Chinese consumer is alive and well!

Third, China's progress in 2024 in transitioning to an innovation-led economy will be key to its long-term economic success. We see China as being at a strategic economic crossroads. On the one hand, China needs to gradually wean itself off the previous growth model based on capital-intensive property and infrastructure. On the other hand, it needs to find replacement growth from other areas, in particular to pivot to higher-value, more innovation-driven sectors – a path previously taken by Korea.

This change of economic direction can only be achieved with ongoing, high levels of capital investment (including human capital) in critical technologies. In some ways, China is already well advanced. Significant advances have already been made in a range of areas including industrial automation, green technology, electric vehicles, autonomous driving, renewable energy, and software. But overall, we view China as being at the relatively early stages of transitioning to a new model based around innovation and the development of new technologies. And it is these areas where investors can find some of the most interesting opportunities, especially now that many stocks have de-rated to more attractive valuations.

The Year of the Dragon will not magically eliminate the headwinds China has recently faced. But with policy responses getting into gear, market sentiment may finally recover, and give due consideration to the exciting innovations Chinese companies are developing.

1 Bloomberg, 29 January 2024

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