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Outlook 2021: China

China's economy is set to continue to recover in 2021. Schroders' equities and debt fund managers, together with our emerging-markets economist, look at what's in store.

Insight from sub-adviser Schroders Investment Management

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Key Points

- Economic growth in China is set to accelerate in 2021 as the recovery continues and the impact of stimulus measures launched this year feed through.
- In equities, sectors providing exposure to long-term growth themes in China should continue to outperform. A broad global economic recovery should also support cyclical sectors where valuations are still cheap relative to growth sectors.
- In Chinese bonds, sound economic fundamentals, attractive valuations, and a positive outlook for the renminbi should all prove supportive.

"FIRST IN, FIRST OUT" SUMS UP THE CHINESE ECONOMY'S COVID-19 STORY. Having suffered its slump early in the year and avoided a significant second wave, China has rebounded earlier and quicker than other major economies, helped by an effective support package.

As we look ahead to 2021, there is broad consensus among our fund managers and economists that this recovery in growth will continue.

But what form will this growth take? Which sectors offer the most interesting opportunities? And what is the outlook for the renminbi?

We gathered the views of our emerging markets economist, as well as equities and debt fund managers to find out.

The Economy

David Rees, Senior Emerging Markets Economist:
We expect economic growth in China to climb to somewhere in the region of 15-20% year-on-year (y/y) in the first quarter of next year. This is due to the lagged impact of stimulus measures, as well as the effect of having a very low base for comparison after the steep economic decline in the first quarter of 2020. However, growth could then decelerate to more normal rates during the course of next year as these effects fade.

After an estimated growth of 2.1% y/y in 2020, we expect China's economy to expand by 9% in 2021.

The fact that the government allowed a state-owned company to default on a bond in November suggests that the authorities' will once again look to rein in credit growth in the year to come.

One issue that may deter policy normalization in the near term is a bout of deflation in early 2021, once the spike in food prices earlier this year washes out of the annual comparison. We expect the strength of the economic recovery to ensure that core inflation gradually picks up during the course of the year. However, in the near term, fears of deflation, at a time when debt is very high, may perturb policymakers and markets alike.

COVID-19 vaccines may actually result in some outflows from the Chinese market, in favor of other economies set to benefit more substantially.

Chinese Equities

Louisa Lo, Head of Greater China Equities, and Jack Lee, China A-shares Fund Manager:

As the economy returns to normal, so too may monetary policy. Particularly with respect to monetary easing, the Chinese authorities continue to prioritize reducing debt levels and curbing excessive borrowing.

While fixed asset investment (FAI), notably in infrastructure and property, has helped support growth in 2020, we expect FAI to shift towards 'new infrastructure' areas in the period to come—in particular, the development of 5G, data centers, and the Internet of Things.

Elsewhere, the habits of Chinese consumers may continue to evolve as their incomes rise. This long-term 'consumption upgrade' theme sees increased spending on a wider variety of higher-quality and more expensive goods and services. This may underpin consumption growth in the country.

Clearly, all eyes around the world are keenly focused on the distribution of the COVID-19 vaccines, and it can determine the timing of the global recovery and alter inflation expectations. However, the availability of a successful vaccine would be more significant for countries where the pandemic is less well-controlled than it is in China.

With this in mind, vaccines may actually result in some outflows from the Chinese market, in favor of other economies set to benefit more substantially. That said, global investors' still-light positioning in Chinese equities and reasonable valuations relative to global peers could encourage further inflows to the market.

From a sector perspective, we believe sectors providing exposure to long-term growth themes in the country will continue to outperform. In particular, we like areas including industrial automation, electric vehicles and components, and supply-chain localization amid international trade frictions. However, a broad global economic recovery following a successful vaccine development should benefit cyclical sectors, where valuations are still cheap currently compared to growth sectors.

From a geopolitical standpoint, the upcoming change in leadership in Washington, DC in January also has implications for China. We think US-China frictions are unlikely to moderate under the new Biden administration, as the view that China is a strategic rival is a bipartisan one in the US.

Indeed, the impact of Biden's anti-China strategy could actually be even more detrimental and impactful as his administrative style may be more coordinated and structured than that of his predecessor.

Chinese Bonds

Julia Ho, Head of Asian Macro:

The valuations of Chinese bonds look attractive, while the country's economic fundamentals are sound. These two factors should drive both demand and potentially attractive returns in 2021.

In terms of valuation, the yields on China's onshore bonds are at compelling levels relative to developed-market government bonds.

The 10-year Chinese government bond, for example, yields around 3.3% currently, while the equivalent US Treasury yields around just 0.8% (as of 11/30/20). This difference in yield (the spread) between Chinese government bonds versus the US Treasury and global developed sovereign equivalents are at record levels.

The result is that the Chinese bond is likely to offer significantly greater potential for price appreciation compared to its US counterpart. This is because bond prices rise as yields fall, and there is less room for US and other developed-market bond yields to decline given their lower starting points.

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Fundamentally, China is expected to be the only major global economy to generate positive economic growth in 2020 as it successfully rebounds from the pandemic slump. Inflation remains subdued as global demand has stayed weak. This favorable dynamic of positive growth with low inflation has provided the central bank with more flexibility in its monetary policy, allowing it to more effectively support smaller businesses.

Technically, Chinese bonds are also in a strong position. Unlike most other emerging markets, Chinese bonds are mostly held by domestic investors. This makes the Chinese bond market less vulnerable to the volatility of global capital flows.

Further support for Chinese bonds comes from the fact they are being included in global bond indices to an ever greater extent. This means that many mutual funds are compelled to invest in the Chinese bond market.

The Chinese currency—the renminbi—is another supporting factor for China bonds. We believe the US dollar is set to weaken over the long term due to the US' large twin deficits (fiscal and current account) and unlimited quantitative easing programs. This could see the renminbi become ever more widely used internationally.

And there are other factors that we think should justify a stronger renminbi in the period to come. These include China's continued economic outperformance, the high interest-rate differential between China and other major economies, the country's improved current-account position, and pent-up demand among global investors who wish to diversify away from the US dollar.

Lastly, we expect onshore Chinese bonds to remain a unique asset class that can help investors diversify their portfolios. The Chinese economic transition to a more domestic consumer-driven market has been accelerated by both US trade tensions and the rise of the Chinese middle class. This domestic focus and "decoupling" from the US would suggest that China's economic and monetary policy cycles may not be perfectly synchronized with other parts of the world.

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