Revenge Spending Starts for the World's Second-Largest Economy

Adam Bass:

This is MSCI Perspectives, your source for insights for global investors, and access to research and expertise from across the investment industry. I'm your host, Adam Bass, and today is May 11, 2023.

While a lot of the financial world was focused on the Potomac this week where fierce negotiations over the US debt limit continued, we set our sights on the China seas. China remains the second-largest economy in the world and an important global player. And the end of their zero-COVID strategy and reopening to the world is still relatively new, at least in terms of the pandemic timeline. But it does bear paying attention to, as global investors determine how to best move forward.

Thomas Verbraken:

There are a lot of links between China and the the global economy, so it's really important to follow what is happening there. But also, I think going forward there will be lots of questions.

Adam Bass:

That's our first guest.

Thomas Verbraken:

I'm Thomas Verbraken, and I work in MSCI's risk management solutions research team, and I'm based out of the Budapest office.

The geopolitical tensions and the potential decoupling between China and other countries is a theme that will keep coming back, as well as domestic developments in China, for example, in the real estate sector.

Adam Bass:

But we're getting ahead of ourselves here. Before we talk about where we might be headed, we do need to take a step back and look at where we've been. For that, we turn to our second guest.

Shuo Xu:

My name is Shuo Xu, so you can call Shuo. Currently, I'm the executive director, and looking after the China-related research topic. In last three years, China has a very strict zero COVID-19 policy, so they locked down couple of living blocks from time to time, and some people asked to stay at home, and the kids, they have to stay at home to take online education course from time to time, as well. So that's a difficult time for everyone. So the economic, and travel, trade, everything, they all slow down a little bit in that three years.

And luckily, we finally reopened, and we tried to exit and drop the zero COVID-19 policy, and we ended that in last year December, and actually, we announced that in end of October. So technically, we ended in last December. After that, we see a lot of international travel is recovering, and domestic travel is also recovered from previous very strict controls.

So every people is very happy and feel freedom now. So maybe I give a very quick example. In last three years when I tried to travel from my home to office, so I just need 30 to 40 minutes to drive, so it's a direct way. So you will see a only a few people, a few cars on the street. After the open up, even during the weekend, there's a lot of traffic jam everywhere. So I spend almost two hours to drive from office to my home, even at night, at around 11:00. So that's terrible, right? But a lot of people just get back onto the street. Everybody is happy, and they get out to enjoy the life here.

Adam Bass:

It wasn't just people who were happy with that change.

Thomas Verbraken:

If you look the equity performance, then you see that Chinese equity started losing in early '21, while other equity markets at that time continued to go up, for example, the US equity market or to a lesser degree also European stocks. And that slow selloff since early 2021, then really intensified in March 2022 at the time of the Russian invasion of Ukraine. That was a combination of global and domestic headwinds. The COVID lockdowns played an important role in the selloff, but there were other things going on. Then actually around the end of October last year, Chinese stocks bottomed and have seen a remarkable rally. So between the end of October last year and the beginning of February this year, the MSCI China index was up by about 50%. And yeah, I think the China reopening with its potential revenge spending and the prospects of a stronger post-lockdown economy were probably an important driver of this rally.

Adam Bass:

Revenge spending. Can you define that for us?

Thomas Verbraken:

Yeah, that's an interesting term, right? You could wonder who is taking revenge on whom. But they use this term to refer to the fact that during the COVID lockdowns, Chinese consumers were saving more than before, because they couldn't spend as much, of course. And some expect that with the lifting of the lockdowns, consumers will start speeding up spending their additional savings. Now, this additional spending could not only have a local effect, but it can also be advantageous to global ex-China companies which are selling to Chinese consumers.

Shuo Xu:

Revenge spending is a word we talked about, I believe, in 2020, back in 2020, because that time, we just had a pandemic outbreak. And we talked about revenge spending after the first time lockdown, and actually, after the three years, people are trying to get out home. They want to spend a lot of money, because they're demanding. The consumption has been under a lot of pressure in three years. They want to eat at a very fine restaurant, they want to travel, they want to watch movies, they want to go to pub, listen to music, a lot of things.

But in China, currently at this moment, I want to maybe make it more precise. What we see here is a need for revenge spending, but it's not there yet. So maybe I can give another example here. There's a very famous tourist space in China we call Sanya. It's actually a beach in Hainan province. It's very famous in China. And everybody, when they have a summer vacation, they will go to Sanya. And this season, we are seeing more tourists than before. If you go back four years or five years back, we have even more tourists now. But it turns out, lower average spending, means people are spending less money per person, which means people are not capable or maybe not willing to spend as much as they did before. So it's a need for the revenge spending, but it's still not there yet.

Adam Bass:

One of the continued areas to watch around China's being open for business once more has been the potential effect on the global economy, and it's a bit of a double-edged sword, as Thomas explained. For example, according to scenarios that Thomas and his team have been analyzing this year-

Thomas Verbraken:

In the hard landing scenario that we go through recession, stronger Chinese growth because of the reopening could prop up global demand and could be a welcome support for the global economy. Whereas in the stagflation scenario, stronger Chinese growth could add to inflationary pressures and make the job of the central banks harder.

Adam Bass:

What about the view from the ground in China, where once again, seems to be rooted in travel?

Shuo Xu:

Before the COVID-19, Thailand is actually one of or maybe the place that China people choose to spend their holidays. And just after we reopen the gate, reopen the board, a lot of people trying to travel to Thailand these days. And we saw that the local price, local service price, including the taxi, even a bottle of juice, the price increase significantly in just maybe a couple of months, especially after January, February, and this month. And some people say, "Okay, so China is trying to export some inflation now."

But let's take another look at the entire thing. Yes, China is trying to spend and import. Maybe sometimes, they buy a lot of things abroad. But if we are looking back at the history, we'll see that China will always export a lot of thing, even more than what it imported, and that the long term, China will play in the long term. It helps to speed up the economy recovery in Thailand, as well. So it will also try to recover the entire industry in Thailand and in a positive way. So ultimately, I think this reopen will not try to maybe make the inflation problem worse.

Speaker 4:

That's definitely in line with research we put out that talked about how globalization had helped to keep inflation low for so long, in that when the world kind of retrenched and looked inward on a national level, that was one of the factors that led to this spike in inflation. Is that in line with what you are you're talking about?

Shuo Xu:

There's many, many reasons for recent inflation. Of course, a lot of people are trying to make the energy the bad guy, right? They're saying, for example, Russia has conflict with Ukraine and it makes the energy price shoot into the sky. And food supply is also not enough. So there's a lot of reasons. And as you just mentioned, China plays a part in that, which means, because China has a long history of very cheap labor force and the product is very cheap here, and sometimes I know people call China as a world factory because it can literally produce everything here and very cheap.

But one thing I try to remind here is, also a very interesting point, because if we are looking at the population, if we're looking at the past 60 years, I mean 60, six-zero, 60 years, the China has always has a positive growth in the entire population. So we always has enough labor for supply in the past more than half a century. But in last year, 2020, we are seeing a decrease in the entire population. It's a negative number for the first time in the past 60 years. Previously, China has a fair story with so-called labor yield, because of more people and more productivity, and maybe can contribute to the global economic growth. But in the next a few years, we will see maybe less labor force join the market and contribute.

That actually worries me about the global economy going forward. So what if China people can only produce less products in the long run, and labor force? And some people know the human cost is increasingly expensive in China, and some people just move their factory to Southeast Asia, because it's maybe even cheaper there. Under that kind of situation, China will trying to balance a lot of growth opportunity, growth target, with the decreasing population. So how that will impact the global inflation? I think it's too quick to make a conclusion here, but I think the globalization could be, ultimate, helpful.

Adam Bass:

While no one can predict the future, whether it's about if increased globalization will once again help keep inflation in check, or well really, anything else, right? We did reference, however, those scenarios that Thomas and team have been looking at, where they look at different possibilities of what may happen and run it through to get output from the MSCI models. Now, you may recall earlier, Thomas spoke about how the hard landing scenario, and he also used the word recession, as well as the role that China might play under those conditions, again, according to our model. In any case, I asked him to expand on that.

Thomas Verbraken:

What I meant is, the global economy goes through recession, at the same time we have the Chinese economy reopening, and we see a strong economic outlook in China, that could to some extent offset the troubles in the global economy, that it could help balance out things a little bit.

Adam Bass:

Thank you for clarifying that. What was the impact on the portfolios you looked at?

Thomas Verbraken:

Well, maybe we can now go a bit more to the China reopening story, because I was maybe staying a bit at the high level, more global, picture. But if you now zoom in a little bit to the, we did a slightly different analysis of what we usually do. Usually we take the top down approach, the macro view, how it impacts broad markets and how it impacts portfolios. Now, we zoomed in a little bit more to the stock-specific level. And what they say about stock markets, namely, a rising tide lifts all boats, in the sense that when the broad stock market goes up, most stocks generally go up, but not all by the same amount. So some stocks are more sensitive to the market and go up more than the market. We usually say they have a beta larger than one. Some stocks are less sensitive, they have a beta smaller than one, and they go up a little bit less than the broad market.

But this movement between broad markets and individual stocks is what we call the systematic return, and that's what we usually use in our scenario analysis. We make assumptions for the broad market and we use that in combination with the stock's beta to the market to determine how each stock will move under a scenario. However, stocks' return also has an idiosyncratic component, which is not driven by the broad market but by stock-specific effects. And that's what we looked at for this analysis. We leveraged MSCI's economic exposure to China. This is a stock-specific data point which tells how much of a company's revenue originates from China, and that information can then be used to determine whether a particular stock would get a positive impact of a China reopening beyond just the broad movement of the market, beyond that systematic return.

We used this framework to assess what happened during the selloff of Chinese equities we were mentioning, as well as the rebound. But then we looked at, okay, what happened to global stocks, global ex-China stocks, with a large revenue exposure to China? And what we found is that if a stock derives a lot of its revenue from China, then it tended to underperform the market during the selloff, whereas it tended to outperform the market, on average, during the rebound.

Of course, within this universe of stocks, there is a lot of variability among stock returns, and the China exposure can only explain a part of those stocks' idiosyncratic returns. But on average, that trend was visible. And basically, when building a portfolio, one could consider using this additional piece of information to not only assess the systematic top-down impact of the broad market, but also a stock-specific revenue exposure to China.

Adam Bass:

What about that look ahead I mentioned at the start of the episode? What's on investor's minds?

Shuo Xu:

When we talk to some asset owners, or maybe some larger large asset managers who has a very robust balance sheet, they might be more conservative on their investment. They might shy away from China investment. They want to keep low risk and be safe.

But for some asset owners, some of them may be underfunded, right? So means they need to achieve a higher growth in the future. They need to capture the high growth opportunities in the global economy. So those investors, they're looking at the opportunities in China, although they know, they are aware, of the existing risks, among them is what I mentioned, that the population is decreasing in the last year. At the same time, for example, they want to make more fair distribution of the wealth. They want to make the health system more accessible for everyone, and even the education system. So for the long run, there's a lot of problem China government need to solve, although it does have a very big potential, like they invest a lot in the high-tech end, so it try to develop its advantages in many aspects.

Adam Bass:

That's all for this week. A big thank you from Joe, Yair, and me to Thomas and Shuo, and to all of you for listening. For insight into how companies and investors, both in China and around the world, are navigating the low carbon transition, I invite you to register for the MSCI Climate Action Conference, which you can do at MSCI.com. You'll find sessions for APAC, as well as the Americas and EMEA. Until next time, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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