

# INVESTMENT NOTE

27 JANUARY 2025

## NEW YEAR, SAME PROBLEMS?



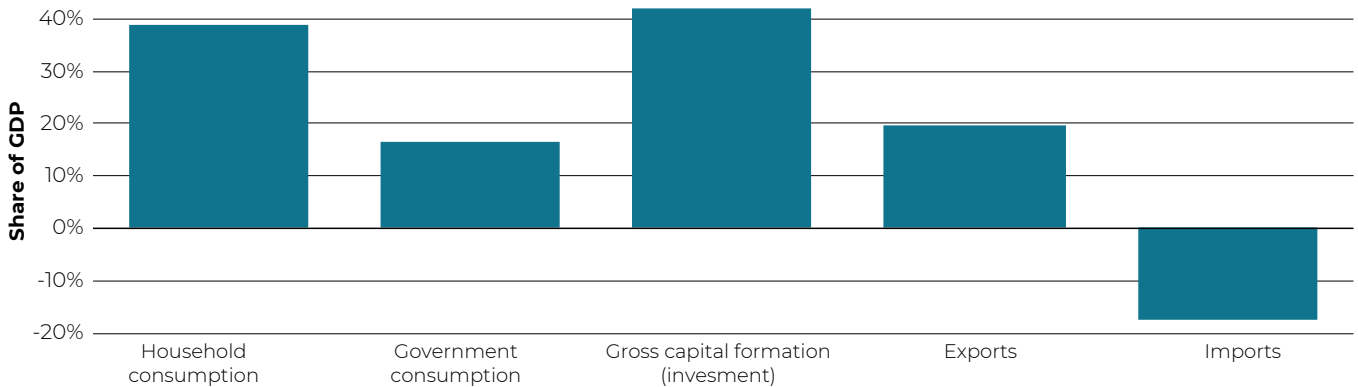
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**While 2025 is in full swing for most of us, 1.4 billion Chinese are only starting their new year this week. The country celebrates New Year on Wednesday according to its ancient lunar calendar. It will be followed by a week (or more) of celebrations, and tens of millions of people are traveling to their hometowns or other holiday destinations. Known as 'Chunyun' in Chinese, it is the largest annual human migration on earth. The fact that it mostly runs smoothly each year is thanks to the country's remarkable transport network, including the fact that China has more high-speed rail mileage than the rest of the world combined.**

This is clearly impressive, but also hints at a rising problem in China: overinvestment. Not all these trains necessarily generate an economic return if ridership is too low or if the construction costs were too high. And yet more are being built. The same is true of investment in general. When a country's infrastructure is underdeveloped, upgrades generate short-term and long-term benefits. However, beyond a certain point, diminishing returns set in. For instance, connecting two towns with a tarred road for the first time will generate positive economic spillovers, which will probably pay for the road many times over. Connecting these two towns with a six-lane highway will also deliver a boost, but not necessarily enough to justify the construction costs. Adding a second road that shaves a few minutes off the driving time is throwing away money. While the rest of the world marvels at China's investment spending, it is simply too high now given its level of development.



**CHART 1: THE STRUCTURE OF CHINA'S ECONOMY BY EXPENDITURE**

Source: National Bureau of Statistics

Yet it continues to invest 40% of national income (GDP) annually, a higher proportion than any other country in modern history. This investment increasingly struggles to earn a return to justify the associated borrowing, and overcapacity abounds. This has been particularly acute in the property sector, where there are millions of empty homes and a swathe of bankrupted property developers.

The flipside is that household consumption is very low by global standards, around 40% of national income whereas it is around 60% to 70% in other countries. This is partly because Chinese households save a lot, but also because they receive a smaller share of income generated in the economy than in other countries. Instead, the public sector (government and state-owned enterprises) receives an

outsized share. Redistribution of this income is unexpectedly low for a communist country, and social safety systems in China are relatively weak, partly due to the 'hukou' household registration system that ties people to their home provinces and denies many migrant workers social assistance in the cities where they work.

When thinking about the outlook for China's economy, it is important not to lose sight of these facts. Despite the remarkable achievements in rapidly modernising the economy over the past 30 years – and in some ways overtaking more advanced Western countries – this is an unbalanced economy. It means that untangling cyclical from structural forces can be tricky.

## ON TARGET

This brings us to the latest economic growth numbers and the outlook for 2025. The Chinese National Bureau of Statistics recently announced that the economy grew 5% in real terms in 2024, in line with the government's target. The data showed some upward momentum in the fourth quarter, which is believable given a lower third quarter base, strong exports (perhaps due to some front-loading of purchases ahead of possible US tariffs) and the impact of several stimulus measures announced in the last few months of 2024.

However, the 5% number warrants some scepticism. As the economist Charles Goodhart famously noted years ago, "when a measure becomes a target, it ceases to be a useful measure." The mere fact that Beijing implemented interest rate cuts and other stimulus measures towards the end of last year suggests that it saw signs of real trouble. If the economy was humming along, these steps would not be needed. For instance, the Rhodium Group, a consultancy, estimates that growth was probably closer to 2.8% in 2024.

The point is not to quibble about the exact number – GDP is always an estimate anyway, not an objective truth – but to think about the direction of travel. The economy has deteriorated in the past two or so years.

What makes it particularly painful is that after decades of consistently strong growth, many business models were built on the assumption that it would continue. Money was borrowed and investments made. People need to get used to lower growth. Think about it this way: no South African would be disappointed with real growth of 2.8%, but that is because our expectations are much lower.

The next question is whether things will improve from current levels, whatever they may actually be, especially given the potential headwinds from US tariffs. President Trump's inauguration was followed by a flurry of executive orders, but we still have no concrete details on changes to trade policy.

Trump's unpredictability will keep Chinese leadership guessing, but they probably also see Trump as someone who is transactional more than ideological. In fact, so far, he has been notably softer on China than expected, with

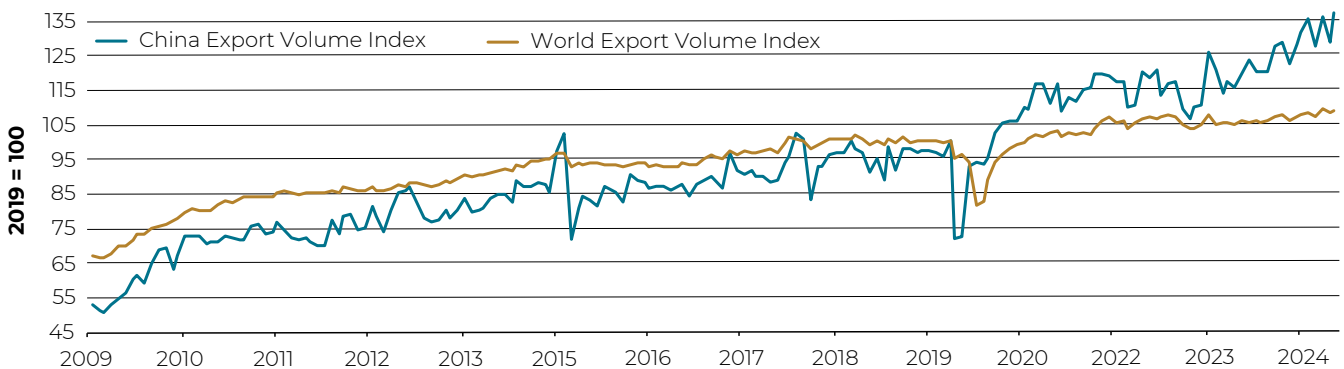
neighbouring Mexico and Canada taking the full brunt of menacing tariff threats. Far from the 60% tariffs on Chinese imports promised on the campaign trail, he had conversations with President Xi and sounds open to deals.

## EXPORT BOOM

Chinese exports to the US are already lower than during the pre-pandemic era, and certainly much lower than where the pre-pandemic trend would've suggested it would be today. Mexico has overtaken China as the biggest importer into the US, though a fair slice of Mexican trade to the north probably originates from China and is simply rerouted. Nonetheless, it is very likely that China's export machine will run into higher US import tariffs. It is just a question of time and extent.

The US is also unlikely to be the last country to object to ever-rising Chinese exports. Increased protectionist tendencies worldwide mean China will not be able to export its way out of trouble indefinitely. Even as exports to the US have been softer, overall export volumes have surged. As chart 2 shows, before Covid, China's export volumes increased in line with global trade. Post-pandemic, it has risen much faster. This is partly because China emerged, almost out of nowhere, as the world's leading exporter of vehicles.

**CHART 2: CHINA AND GLOBAL EXPORT VOLUMES**



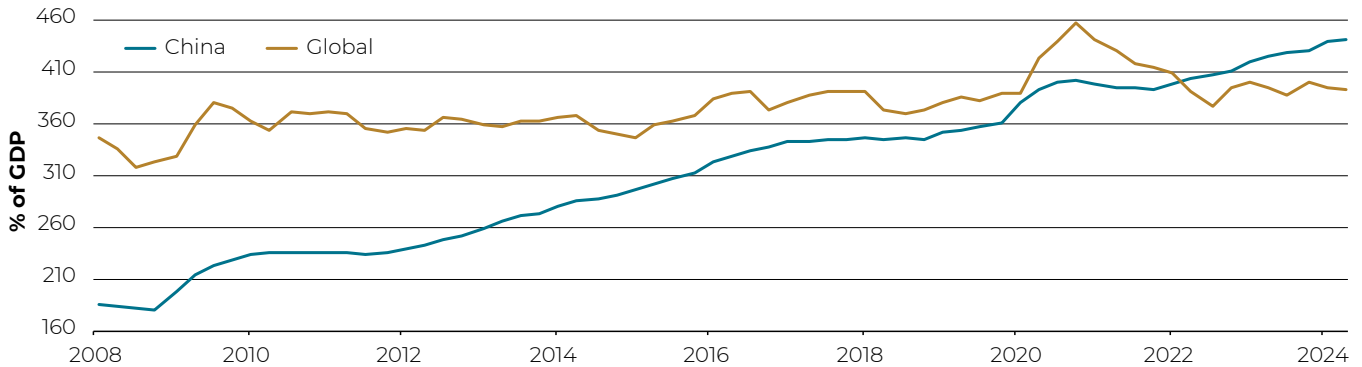
Source: CPB World Trade Monitor

But it is also because Chinese firms have no choice but to export in the face of domestic overcapacity and sluggish demand. Desperate for sales, firms have cut prices to win market share at home and abroad. While falling prices are good news for consumers, when an economy faces persistent deflation, across broad categories, it is problematic for two reasons.

Firstly, faced with persistent price declines, people delay consumption and investment decisions. Why buy something today if it will be cheaper tomorrow? Eventually deflation can become a mindset, a self-fulfilling prophecy, and completely sap an economy of dynamism.

Secondly, since one person's inflation is another's income, deflation implies falling or stagnant incomes. It might also imply falling asset values, such as house prices. However, the value of debt does not adjust lower. If you borrowed \$1 million to buy a house, you need to repay \$1 million plus interest even if your income is lower than what it was when you took out the loan, and the property is worth less.

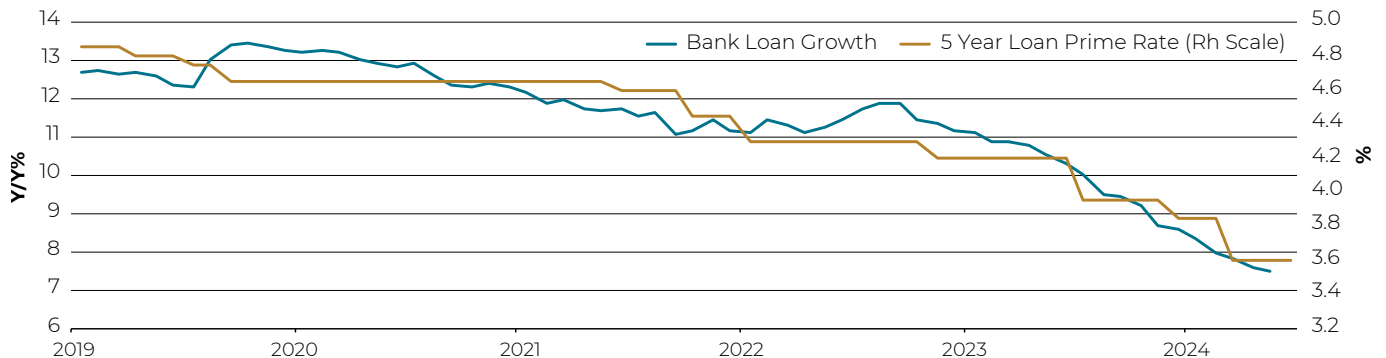
Therefore, debt and deflation are a particularly pernicious combination, more so if it occurs after the bursting of a property bubble. China's overall debt level has increased much faster than the rest of the world over the past decade.

**CHART 3: TOTAL (PUBLIC AND PRIVATE) DEBT-TO-GDP RATIOS**

Source: Bank for International Settlements

Even worse, is adding a third “d” – demographics. Official statistics show that China’s population declined for the third straight year in 2024. This is not just a consequence of the one child policy, since Chinese families are now encouraged to have more children. It is yet another sign of a lack of confidence in the future among ordinary Chinese.

In turn this means that lower interest rates haven’t helped much. There is declining appetite to borrow on the part of households and businesses even though the People’s Bank of China has cut interest rates, as chart 4 shows.

**CHART 4: LOAN GROWTH AND INTEREST RATES**

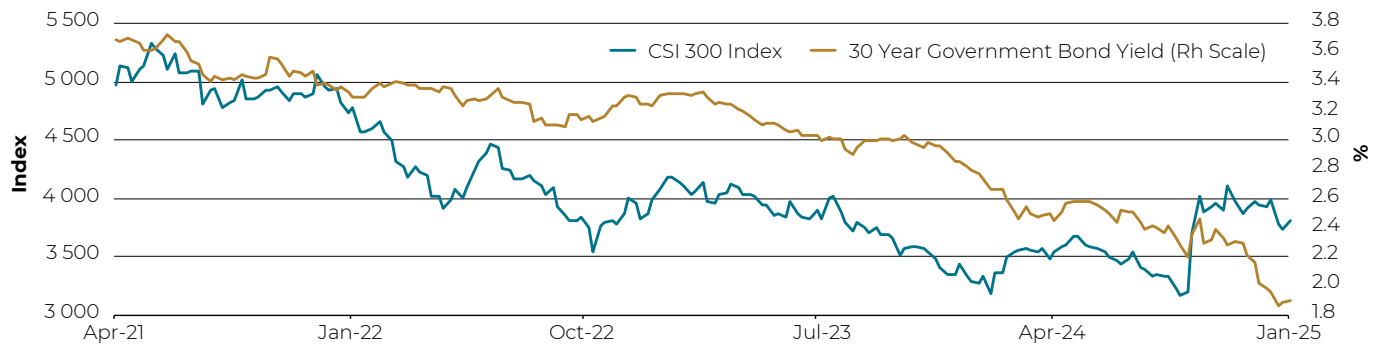
Source: LSEG Datastream

Further complicating things is the currency. Unlike in South Africa, where the rand is an important pressure release valve, the tightly controlled yuan cannot play the same role for China. A weaker yuan could offset the impact of tariffs and boost export earnings, but it could also spur capital flight, something Beijing has been very wary of. A weaker yuan would also further antagonise countries who accuse China of unfair trade practices.

In a deflationary environment, fiscal policy is the best response. The central government must be the borrower and spender of last resort, utilising the prevailing low interest rates to stimulate the economy. The big question for 2025 is therefore if a sizeable fiscal package is on the way. It won’t be of the same magnitude as the 2009 “big bazooka”

stimulus, but it can be big enough to give the economy renewed upward momentum. This in turn should be positive for other emerging markets and commodity producers like South Africa (we’ll focus on the latter next week).

However, the long-term problems remain and require deeper reforms to prevent China’s potential growth declining over time. Notably, a better balance between household consumption and investment is needed. The sharp decline in long bond yields suggests market participants do not expect these reforms to be forthcoming. The 30-year bond yield has fallen from 3.8% at the start of 2021 to 1.8% at a time when bond yields rose in most other countries.

**CHART 5: CHINESE BONDS AND EQUITIES**

Source: LSEG Datastream

The equity market also reflects a distinct lack of enthusiasm. Apart from the one-off jump in September 2024, when the People's Bank set up a special facility to boost equity values, Chinese equities have been lacklustre. An announcement that state-owned insurance companies would have to buy more equities has helped a bit. In turn, the soft performance of Chinese equities has weighed on the broader emerging market equity asset class.

Nonetheless, the question investors must always ask is not whether the news is bad, but whether the bad news is sufficiently priced in. There are bound to be bargains in such a beaten-up market.

To conclude, according to the Chinese Zodiac, 2025 will be the year of the snake. While that sound ominous since many people are scared of snakes, these incredible animals are known for their ability to shed their skins. This symbolises renewal, letting go of the old, and accepting the new. The question now is whether China can successfully let go of the old investment and export-driven growth model and embrace a new one. The answer has huge implications not just for its citizens, but also for the global economy.

## EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	3 857.0	2.09%	4.02%	4.02%	20.38%
United States	S&P 500	US\$	6 101.0	1.73%	3.72%	3.72%	25.30%
Europe	MSCI Europe	US\$	2 127.0	3.35%	6.19%	6.19%	6.99%
Britain	FTSE 100	US\$	10 612.0	2.54%	3.75%	3.75%	10.80%
Germany	DAX	US\$	1 906.0	4.32%	8.36%	8.35%	19.27%
Japan	Nikkei 225	US\$	256.0	4.04%	0.86%	0.86%	4.23%
Emerging Markets	MSCI Emerging Markets	US\$	1 090.0	1.87%	1.40%	1.40%	11.00%
Brazil	MSCI Brazil	US\$	1 271.0	3.08%	7.99%	7.99%	-24.93%
China	MSCI China	US\$	64.2	2.98%	-0.45%	-0.45%	24.18%
India	MSCI India	US\$	976.8	-0.92%	-4.61%	-4.61%	5.37%
South Africa	MSCI South Africa	US\$	448.0	1.59%	4.19%	4.19%	16.06%

## EQUITIES - SOUTH AFRICA (TOTAL RETURN UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	84 291.0	-0.48%	0.23%	0.23%	13.42%
All Share	All Share (Total Return)	Rand	15 424.0	-0.45%	0.33%	0.33%	17.63%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	37 879.5	-0.51%	0.66%	0.66%	17.87%
TOP 40/Large Caps	Top 40	Rand	13 736.0	-0.31%	0.84%	0.84%	15.73%
Mid Caps	Mid Cap	Rand	24 901.0	-1.99%	-0.97%	-0.97%	18.60%
Small Companies	Small Cap	Rand	42 666.0	-0.76%	-3.65%	-3.65%	29.95%
Resources	Resource 20	Rand	5 183.7	1.87%	14.93%	14.93%	15.13%
Industrials	Industrial 25	Rand	25 568.0	0.54%	-1.79%	-1.79%	16.33%
Financials	Financial 15	Rand	15 144.0	-3.07%	-3.55%	-3.55%	21.20%
Listed Property	SA Listed Property	Rand	2 322.5	-1.51%	-3.35%	-3.35%	22.95%

## FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
IBOXX Global Government S&P Overall (USD Unhedged)		US\$	74.1	0.86%	0.30%	0.30%	-2.72%

## FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	1 107.6	1.20%	0.45%	0.45%	16.89%
Government Bonds	BESA GOVI	Rand	1 090.7	1.20%	0.45%	0.45%	16.77%
Inflation Linked Bonds	BESA CILI	Rand	374.1	-0.27%	-0.67%	-0.67%	7.35%
Cash	STEFI Composite	Rand	597.7	0.15%	0.51%	0.51%	8.43%

## COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	78.5	-2.83%	4.67%	4.67%	-1.88%
Gold	Gold Spot	US\$	2 770.0	2.55%	5.89%	5.89%	36.39%
Platinum	Platinum Spot	US\$	956.0	0.74%	4.48%	4.48%	6.46%

## CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	18.40	1.88%	2.35%	2.37%	2.64%
ZAR/Pound	ZAR/GBP	Rand	22.97	-0.70%	2.87%	2.87%	4.66%
ZAR/Euro	ZAR/EUR	Rand	19.32	-0.35%	1.20%	1.20%	6.43%
Dollar/Euro	USD/EUR	US\$	1.05	-1.90%	-1.43%	-1.43%	3.81%
Dollar/Pound	USD/GBP	US\$	1.25	-2.51%	0.15%	0.15%	1.75%
Dollar/Yen	USD/JPY	US\$	0.01	-0.19%	-0.76%	-0.76%	5.76%

Source: I-Net, figures as at 24 January 2025

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