

All the Credit[®] Episode 38

Transcript

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Mike Collins, CFA, Host and Senior Portfolio Manager, Multi-sector Strategies: Hello. Welcome to Episode 38 of *All the Credit*, PGIM Fixed Income's monthly podcast. I'm Mike Collins, just one of the many investment professionals at PGIM Fixed Income and your host of *All the Credit*. I'll be joined by another co-host in this episode, my London-based colleague, Michael Roper. Mr. Roper is a Portfolio Manager on our European Investment Grade Corporate Bond team and Mike has also held stints in Investment Grade and High Yield Credit Research during his 13 years at PGIM Fixed Income. And Michael has a Master's degree in Economics and Finance and is a CFA charter holder. Michael, welcome to your inaugural co-hosting role. I'm really excited to have you join us today.

Michael Roper, CFA, Portfolio Manager, European Investment Grade Corporate Bond: Yes. Thanks for the introduction, Mike, and great to be here.

Mike: And this episode is really timely, China is really dominating many of the recent headlines. After suffering through years of draconian COVID-related lockdowns, China's domestic consumer economy is rapidly reopening. At the same time though, we're seeing global manufacturing trends which is, obviously, historically, China's wheelhouse are being challenged by tighter credit conditions after years of aggressive central bank policy tightening. And now, global banks tightening their lending standards and, of course, China finds itself in the geopolitical crosshairs as evidenced by more hawkish policies toward China, particularly from the U.S.

Michael: Yeah, that's right, Mike. In this podcast, we're going to do a deep dive on China. There is so much to get through here. So, let's just flesh out what we're going to discuss. We'll start with the reopening progress so far. We're going to explore how this Chinese cyclical upswing may be different from other rebounds, we're then going to provide our forecast for economic growth, and importantly, inflation trends in China and how these drivers may affect other countries. We're then going to jump on and assess China's likely policy initiatives and what that might mean for their interest rates and currency. And then, we're going to back away from the current cycle and lay out our expectations for longer-term forces and trends in growth. And then, of course, there's also no escaping geopolitics and the implications of that for both China and their trading partners. And then, finally, we'll wrap it up with investment implications and how we are positioning our portfolios with regard to Chinese exposure.

Mike: Great. So, we have a full episode today. Let's get right to it and here to decipher the China situation is our very own Gerwin Bell. Gerwin is the Lead Economist for Asia at PGIM Fixed Income. Prior to joining just over a decade ago, Mr. Bell was a mission chief at the International Monetary Fund or the IMF responsible for negotiating IMF loan programs for a number of countries shaping debt restructuring policies and he also oversaw nation-building efforts in the Balkans. Prior to the IMF, Mr. Bell taught at both U.S. and

German universities and Gerwin received his master's degree in economics from Yale University and a PhD in economics from Trier University in Germany. So, Michael, Gerwin and I are here to give you all the credit. Welcome back to *All the Credit*, Gerwin. I mean, you were on just about two years ago talking about China with us then and wow, a lot has certainly happened. So, why don't we start with the big picture on China's economy? You know, how is this reopening going and how do you translate that into your kind of near-term GDP and inflation forecast for China?

Gerwin Bell, PhD, Lead Economist for Asia: Thanks for having me, Mike. It's really been a while and you're right, a lot has changed but really, really happy to be with you on the podcast again. So, one thing you need to keep in mind when discussing the China reopening, it's unlike any other country's reopening. It's completely different. Why is it completely different? Because China's lockdown and pandemic experience was completely different. And for Western audiences, it's important to see how the lockdown worked in the West. We shut things down, we let people stay at home, we gave them transfers to keep a standard of living going and to buy goods. Now, where are these goods made that people needed? The Pelotons, the PCs, the laptops, the microphones, well, they were made in China. So, Chinese factories stayed open throughout through the entire three years and saw a yet another huge Chinese export boom. So, the entire stimulus check global demand landed on China's factory gates and they were met there. So, in contrast to the rest of the world, Chinese consumers weren't padded with couches and stimulus, they had to work and they met import demand across the world. So, what we now have to deal with is an economy globally that has reopened, factories in the U.S. and elsewhere are open, and stimulus checks are running out. So, we see declining household incomes particularly in real terms. Now, the Chinese consumer has to come back because yeah it's unlikely that exports are going to go further. The Chinese consumer is not in as cash-rich a position as the rest of the world has been so it will be a consumer-led recovery that is drawing on fewer resources. We've seen the first instance of this in first quarter data for 2023. It was clearly a consumer-led recovery.

Michael: Yeah, Gerwin, you spoke about how Chinese reopening is different from others and the importance of the consumer-led recovery. So, how might this economic rebound in China also be different than many of the recoveries you've seen out of China over the past few decades?

Gerwin: Yes. I mean, I think it's going to be quite difficult because the traditional way of boosting Chinese recoveries, at least after the global financial crisis in 2008 has been flooding of credit to get investment, public investment, particularly property investment going. These investments typically needed large amounts of commodity and capital goods. So, there was always a very, very good sign for say commodity exporters like Chile, Brazil, Australia, and then capital goods exporters like the European manufacturers, particularly German and Eastern Europeans. This is a very different animal. The Chinese consumer doesn't consume copper and they consume maybe food products so that might be helpful for active exporters like New Zealand, but they do tend to consume domestically produced services. That is not something that the world has seen. So, there will be much less of a spillover of Chinese growth into global growth, and it will also be much less of a spill over into most commodities. Of course, there are some commodities that are different, and I would mention oil. Oil is also relevant for the consumer, for the services industry, and we see an uptick in Chinese travel and flights in the city travel. So, I can see that transport-related commodities will be supported but the copper, cement building, road building, railroad building stimulus, I think, that's not what we're going to see this year.

Mike: So, you touched on it briefly there but perhaps you could just give us a little bit more about what is actually happening in the property sector in China. From the headlines, I see it still feels like a difficult story.

Gerwin: Yeah. The property sector, again, to give a bit more perspective and everybody has always worried about the property sector. I mean, the Chinese property market is the most expensive in the world in international comparison. Also, Chinese households own the most property in international comparison. So, clearly, there was a sustainability question. During the heights of the pandemic, unfortunately, the Chinese authorities decided to do something about it and to go after over levered property holders. There was the so-

called 'three red lines' policy and that triggered a massive, massive shock to the property sector. We've seen property developers before, we've seen buildings not being finished, and we've seen households become much less convinced that property is a safe store of value. And all-over last year, 2022, the property sector performed absolutely abysmally, has a huge growth strike and with declines in the double digits. However, since the Communist Party Congress in October, there has been an active effort to get property going again. In other words, unwinding the previous three red lines policies. We've seen some effort toward the end of the year in finishing unfinished buildings, so that has led to an increase. And post-Chinese New Year we've also seen some incentive schemes for home purchases to go up. They went up in better markets but already the March data indicates sort of a flattening of demand. I would say the property sector, it has recovered a bit but it's far from being out of the woods and we still have three-quarters of the year to go. So, that's a continuous worry in part for me.

Mike: I like your concept that this really isn't your father or grandfather's typical Chinese recovery, Gerwin, right? The contours are very different and you touched on it a little bit. But specifically, which countries—if you're a foreign investor—which countries will benefit from this type of rebound versus past recoveries? You know, you touched on the commodities and maybe steel and iron ore, and the big building construction commodities, copper, don't benefit, maybe it's more oil and gas. So, how is it different?

Gerwin: I would definitely think that oil and gas will be supported. You need energy for pretty much anything albeit manufacturing, albeit consuming. I mean, it's energy intensive and I think that supports also our still reasonably bullish oil price forecast in PGIM. What else it supports? I think it support higher quality food. Like, for instance, New Zealand is probably a better place to tap into that market. Then, of course, the big thing that has been different in the last three years is the Chinese tourists. We haven't seen the Chinese tourists. So, now, we go out in New York, we see people finally arriving and going into luxury goods markets. Also, that could help. But the more typical Chinese household tourists goes to places like Thailand, like Malaysia, India, Indonesia, Philippines. There, we've seen the emergence of an uptick. We're still far from being at prior level. So, I would think that the nearer regional tourist hubs, including Singapore, will benefit from it.

Michael: And if I could just chuck on a European hat here, Gerwin, higher energy prices and a predominantly consumer-driven recovery, you know, that doesn't sound like great news for Europe. I think a lot of people are holding out some hope that the Chinese recovery would boost exports especially out of places like Germany.

Gerwin: Yeah no, it doesn't. In particular, if you add the fact to this European natural gas imports last year actually were rerouted from China, China not really needing the contract with LNG and shipping it on to Europe. So, that's a thing of the past. Also, China's industry has been upgrading. That's something that's been going on. So, if you look at who are the electric vehicle leaders in the world. Well, other than Elon's Tesla, it's Chinese firms. And Chinese firms enjoyed sort of a clean sheet from which they built so they don't have legacy platforms to electrify like the Europeans do and they're very price competitive. And it's something that the Chinese market wants. It's arguably also something that Europeans have to get used to if they incentivize electric vehicles that a lot of the cheaper offerings will come from China. So, there's a very different mix to it than before. But having said that, I mean, highly sophisticated manufacturing capital equipment still largely comes from Europe. But if I'm right, it will not be a traditional or manufacturing output from Europe going into China.

Michael: So, this is not credit fuel boost to the property sector and we're seeing also large tech companies come under pressure. What levers or domestic policy changes can China utilize to support and prolong the recovery? And then, maybe, you can also answer in terms of how we should think about interest rates and the Chinese currency.

Gerwin: So, you mentioned the tech sector. There's another, I think, self-inflicted wound that the Chinese took by taking on the technology unicorns like Alibaba, like Ant, like Tencent and you've seen somewhat of a turnaround now seeing that these are really the most innovative and valuable Chinese companies. And we may not want to stand in their way any further. Now, the question is similar to the property sector, how much damage has been done to the confidence in the Chinese tech sector? And then, especially, if you put this into a bigger geopolitical context where a lot of the rest of the world are not exactly eager to share data with China. So, China is at risk of becoming a data island and that can't be good. I mean, it's a big market but if you can't participate in the rest of the world—and we've seen what's happened with TikTok in the U.S.—it's a risk for them. On the macro level, there is a huge debt load problem in China, that hasn't gone away. So, it's about, give and take, 300% of GDP. Just a little calculation here. So, 300% of GDP at an average lending interest rate of between 5% and 6% So, it's 5. That gives you annual interest expense of 15% of GDP. Nominal GDP growth in China is 6%, 7%, 8%. So, annual interest expense is twice the level of what could organically be met from GDP growth. That means that you actually have to borrow now to pay your interest. Never a great story. So, I think that's also imbedded in our view on Chinese interest rates. Chinese interest rates still have to come down to make the debt servicing cost less. That will then, of course, also have an impact on the exchange rate with which, in our view, is on a weakening trend. So, these macro factors would boost nominal growth and lower interest servicing costs. And I think they're essential given the debt load that China has amassed.

Mike: Yeah. I mean, those are really a lot of cross currents, right? They're trying to crack down on the over levered sectors, but they're also trying to spur growth through different domestic policies and keeping their rates low. And as you mentioned, the big secular trends have really gotten worse in China and seemed like they've accelerated to the downside since COVID. I mean, their debt has ballooned at 300% of GDP. It's a lot higher than it was even a few years ago. I'm just looking at the demographics—which have been a headwind in China with their one-child policy for years—seems to be accelerating. Birth rates are plummeting and in a lot of parts of the world, but certainly in China. What does that mean for your long-term GDP? What's your GDP forecast for China for this year? And on average you mentioned it used to grow at 8% and 6%, what is going to be their potential GDP and inflation rate for the next five or 10 years?

Gerwin: That's a great question. So, the near term is easier, particularly after the first quarter. So, we have been higher than consensus at 5...5.75% since last year. I think now consensus is moving beyond this on the basis of the first quarter. So, I wouldn't be very worried at this stage about the 2023 growth forecast. However, even the five, top five, -sixish GDP growth forecast, we don't see any inflationary pressure in there. So, if my December and December's CPI forecast is 1.2, I wish the Europeans and the U.S. would wish for a forecast like that for a change again. Now, why is that? Because of some of these trends that you mentioned, Mike. I mean, there's this significant excess capacity already in China, even the rebounding consumer will not lead to a huge domestic demand surge. And this aging society is saving and they're already sitting on a lot of apartments, at least the wealthier are so. So, then, the question now, in the medium term, what are going to be the fundamental growth drivers in China? And they don't look great. So, the population labor force does not look great. There is a way to increase the retirement age which is very early in China. But much to the amazement of people who think China is a totalitarian monolith, I think this is something that the government, that the authorities would shy away from in order to not trigger popular backlash. So, population doesn't look great. You mentioned the debt burden, there's not much more we can add on this in order to pile in already high investment shots. And then, above all is what the economists call a total factor productivity. So, how good are you in using your resources and generating growth? Over the last 10 years, that measure has rapidly declined. So, all three key fundamental drivers of growth in China are pointing south and we have this embedded in our forecast for the next year which goes on for 4.5%. Over a five-year period we think we're clocking in growth below 4% is potential. Over 10 years you see the potential is less than 3%. So, these are very, very, very different trends which call into the question the idea that China may ever overtake the U.S. in nominal GDP terms.

Mike: Gerwin, I know your background is an economist, but we're not here to give you an easy ride and I think we have to address the elephant in the room when it comes to China which is geopolitics. Whether that's China flexing its military might in the region, forcing other countries, especially the U.S. to exert more economic and trade pressures, or it can increasingly crop up in terms of its role in the Ukraine-Russia crisis, what do you think will happen? How will this play out? And really, what are the big risks that this tension imposes on the world?

Michael: What we have seen is the seed change how the Chinese authorities see their role in the world. It used to be, prior to Xi Jinping, that China was biding its time and never pushing into the forefront. Xi Jinping has a very different view about China. He sees China as a global act that needs to be in the forefront including leading regionally and pressing for its interests. And that is best understood in the initial South China Sea Island building and massive naval expansion. So, what it is not, at least not so far, is a global power projection. I mean, that may be a next step. So, from China's perspective, it's primarily a regional play for the dominant power to get its interest afloat, not too dissimilar to the Monroe Doctrine in the U.S. and in Latin America. Now, unfortunately, the South China Sea is the major trade route as well for all kinds of global trade and shipping. So, even if these were a valid view for China to control this, the rest of the world does not put up with it. So, that triggered immediate backlash that, I think, was poorly understood in Beijing as well. So, this is not like we want to have our own backyard protected, no. Your backyard is our key shipping and supply lines and we don't want you to dominate. From then on, things got, kind of, worse. First on trade, and now increasingly on high tech and trying to innovate and limit China's scope to either spy on high tech or China's scope to draw by having access to key inputs. So, I think that's where we are, that's where we're going to stay. I don't think, but again I'm an economist, but I don't think that there is a very high risk over conflict escalation in Taiwan. We hear that the military experts in the U.S. think it is a high risk. But, I mean, the Chinese would know that Taiwan would be a poisoned chalice. I mean it's difficult to take. I mean they saw how Russia struggled to get the 80 miles or so from Russia to Kyiv. Crossing the Taiwan Strait against the barrage of anti-ship missiles is harder. And then, even if they take over Taiwan, they would face a non-receptive population. And then they would find out they can't actually run Taiwan Semiconductor Manufacturing Company Limited (TSMC), which is a very high skill thing. So, even if the factory wasn't damaged, the Chinese couldn't run it. So, I tend to discount the direct military escalation, but given this decoupling, friendshoring, I mean, raising trade restrictions, military buildup in the region, I wouldn't discount the chance of an accidental escalation. So, it is worrisome, in my view.

Mike: Well, let's hope you're right and that there isn't any escalation, that would be obviously disastrous. But China is expanding their kind of reach into the world in other ways, right? I mean, they've become the largest kind of external creditor to a lot of developing nations. In fact, you just recently penned a blog called "Cutting the Gordian EM Restructuring Knot," which basically talks about this dominance. So, just quickly, our listeners can look on the Bond Blog which is on our website and quickly find this piece which is pretty detailed. But just quickly, just summarize kind of the key issues on that front.

Gerwin: You're right, Mike. I mean, the world of official bilateral debt in emerging markets has changed dramatically over the last 15 years. And to give you some context, for many low-income countries, debt was wiped out in part as the highly indebted poor country initiative, the Multilateral Debt Relief Initiative. Since then, these countries borrowed like there's no tomorrow, many of them. A lot of that debt came from China. So, China, from being an absolutely negligible creditor, is now the world's largest official creditor to these countries—I mean, two-thirds of that is Chinese. Now, as typically happens—and we're bond guys so we are a bit cynical—so, it typically happens if you borrow a lot, you find yourself in a situation that it's difficult to pay back once the first maturity comes and that's where we are. So, a lot of countries over borrowed, they need relief. Some of them have defaulted on private debt. But in terms of how these things have historically been dealt with, everybody takes a cut, everybody has to provide some debt relief. The Chinese don't want to embrace the traditional way the official public creditors have done it by providing NTV debt relief via principal haircuts and that has led to a standstill and that's where the number of IMF programs are held up on

this. And in the blog, I just made a proposal how to get around this by having the IMF, in essence, lend to countries on condition that they run payment arrears with China and that at least would help resolve some pretty untenable economic and social situations in some of these debt-distressed countries.

Mike: Yeah. So, none of that sounds great for the emerging countries with a lot of debt, but nor for China, right, which has lent a lot of its money and may not get a lot of it back to kind of add on to—

Gerwin: Yeah, right. It's nothing new. I mean, Western development banks went through the same thing. So, what really holds up China is—if you're a director of a bank lending institution and you run the risk of criminal charges if you lose state property, right? There's a claim on a different country, its state property. So, you're not going to underwrite a principal haircut. So, there has to be a more coordinated decision in China for how to handle this and I think the threat of being in arrears as an IMF condition will get you there. So, that's the point of the Bond Blog. So, not to despair, we're going to solve this like we solved the Latin American debt crisis, but then what happens?

Mike: Sure, sure. So, as we get close to wrapping up today's podcast, I'll just quickly summarize for our listeners how we're generally positioned on China. If you look at Chinese spreads, there's sovereign credit default swaps on five years kind of trading in the 70s, right, pf basis points. We don't think there's enough value in China sovereign or even a lot of the quasi-sovereign. Certainly, there are corporate debt to take positions. We've been underweight, generally been very defensively positioned across our emerging market and even our broader multi-sector portfolios. Certainly, with regard to China property companies. With regard to the interest rates, yeah, I mean, maybe they keep going down, but their 10-year local rate is like at 280 bps right now and it sounds like, Gerwin, it needs to go further. So, we're neutralish on that thinking, they've been going in the opposite direction of other global rates. And certainly, with their monetary policy, they haven't been hiking this cycle—one of the few central banks that haven't. And their currency, the Yuan or Renminbi, has kind of bounced above 7%. Meaning, it's weakening when it goes above 7% and it's kind of pushing toward that level so a little bit underweight or short their currency as well.

Michael: Gerwin, that was great. I mean, it feels like we've managed to squeeze a huge amount of material in there and probably could spend 30 minutes on any one of those topics discussed. My takeaway from this is how different this recovery feels in China versus previous rebounds, but I'll leave it to you to provide any final comments, takeaways that you want our listeners to walk away from this podcast with.

Gerwin: Two points that I always hear from people who don't follow China that much that I think need to be more nuanced. One is the decoupling thing, your friend-shoring, near-shoring, that will drain China. That has not been the experience. China is the global factory. It's meant to be the country that manufactures for the world. You can't unravel that quickly. Now, then to the extent that people say, “Look at Vietnam, look at Mexico, where we have this near-shoring.” Yes, it's true, you do, but for all the increased exports from Vietnam and Mexico due to the U.S., they import more than that from China again. So, it's just a less efficient form of trade that will leave China, in the end, the factory of the world. So, I wouldn't put too much stake into this global decoupling. High tech, I can see because it's a much more separable, but for your continued, your microphones, your computers, stuff like that, in the end, there have been this massive manufacturing in China. The other thing is the role of the U.S. dollar and the Chinese taking over the reserve currency status. For a country, the debt load like that that has no capital account is not free and domestic citizens can't take their money out. So, in other words, you have to still lock your domestics and that doesn't sound like a great mix for foreigners who willingly put their money in there and then take it out in times of need. So, these are two things, I think, that get discussed too much rather than a more realistic scenario where we need to worry that perhaps the Chinese may also now, when they see a chance to, target sanctions to the rest of the world. I don't know where. They have some critical raw materials and stuff. So, it's a general thing on China. It's just that they need expect volatility. But on the macro, I would think they keep the house in order so I would not expect them to be a source of macro volatility, but a source of volatility in politics, in particular, trade matters.

Mike: Thank you very much. I mean, that was great. Gerwin, as Michael put it really well, I mean, squeezes a lot of really interesting information here. So, thank you, Michael Roper, for co-hosting. Thank you, Gerwin Bell, for all that great commentary. And for our listeners, again, you can look at the Bond Blog. Just type in Bond Blog and it pops right up. It's the PGIM Fixed Income blog and there's a lot of really kind of hard hitting, concise thought leadership that we put out in there. And you can also look at our website which is PGIMFixedIncome.com for all of our quarterly outlooks and Weekly Views from the Desk and all of our other thought leadership. So, thank you for listening. Until next time.

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