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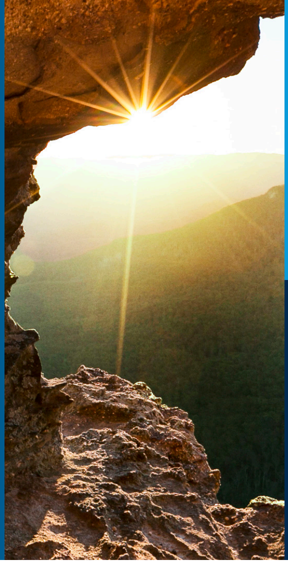

BIG PICTURE
Stimulus Fatigue: China Can't Band-Aid Its Way to Recovery

MACRO INSIGHT | Q1 2025

Since September 2024, Chinese policymakers have focused on delivering a series of stimulus packages to inject new life into their struggling economy and boost share prices. However, high debt levels, overinvestment, an unresolved property bubble, underwhelming domestic consumption and international trade pressures are all contributing to the structural weaknesses in China's economy that mere stimulus packages cannot resolve.

Structural Concerns: Debt and Overinvestment Caused Productivity Decline and Deflation

At the core of China's challenges lies its staggering debt, with a total debt-to-GDP ratio soaring to around 350%. The state's dependency on debt-fueled expansion has eroded productivity, as each yuan injected into the economy yields diminishing returns. Another major challenge is overinvestment, with nearly 45% of China's GDP funneled into projects that now face dwindling domestic demand. This flood of excess capacity has led to lower utilization rates and deflationary pressures in both producer and consumer prices. The recent dip of nominal GDP below real GDP is troubling, as it directly impacts corporate earnings and, by extension, investor confidence and stock market stability.

Property Bubble: An Anchor of Wealth Has Turned Into a Liability

The property market, a pillar of Chinese wealth and economic activity, is under significant strain. With around 60 million empty units and declining property prices, the positive wealth effect real estate once offered is now a drag on the economy. Property represents about 60% of China's net worth, in stark contrast to the United States, where it's closer to 27%. This reliance on property as a store of wealth makes the country vulnerable to downturns in real estate. Any effective economic solution must address challenges within the property sector and its cascading effect on wealth, consumption and financial stability.

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Consumption and Exports: The Great Divergence

Efforts to boost domestic consumption have largely fallen short. The effectiveness of loose monetary policy in boosting consumer confidence starkly contrasts with the U.S. In China, a significant portion of household net worth is tied to real estate. Unlike in the U.S., where lower interest rates encourage spending, Chinese consumers hesitate to boost their spending due to fears surrounding property market instability and lack of a social security net.

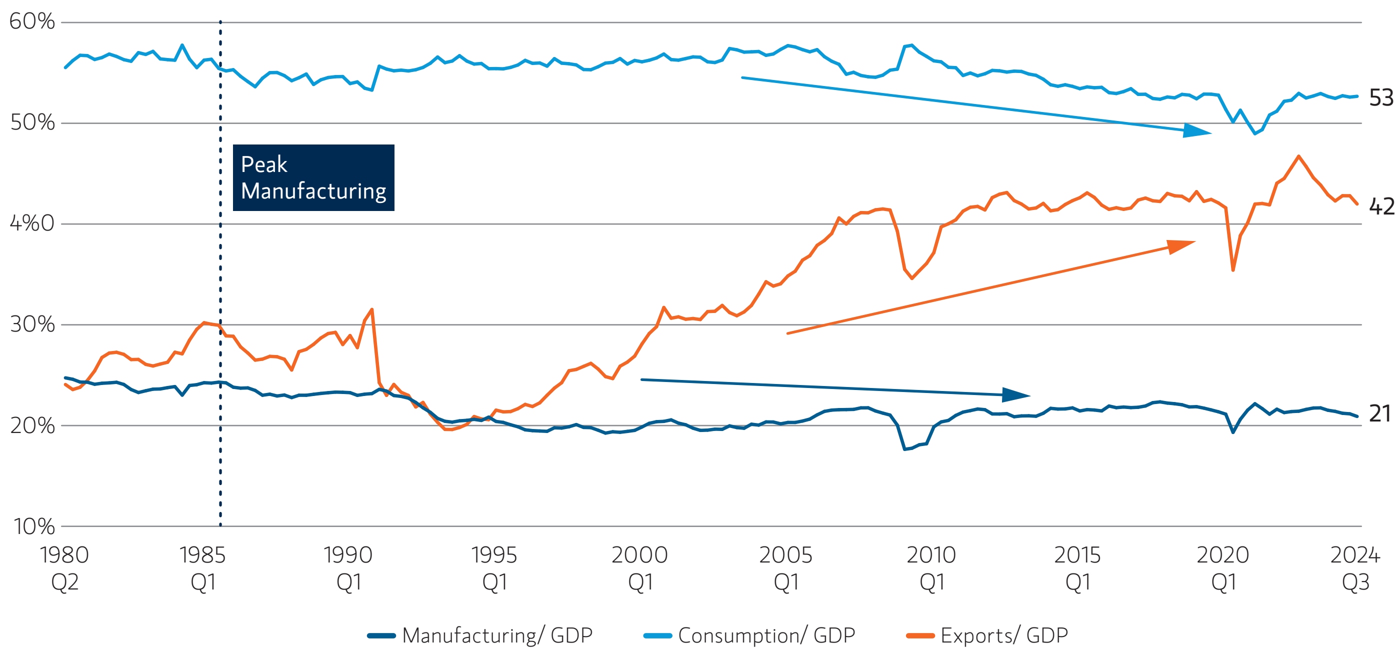
So far, consumption has been overshadowed by ongoing investments in manufacturing, trade and infrastructure. The "Made in China 2025" initiative pushes Beijing to climb the value chain by producing higher-end goods, from electric vehicles (EVs) to aerospace technology. Yet, as domestic demand remains insufficient to absorb this output, China increasingly relies on exports to sustain growth. While household consumption accounts for 72% of global GDP, it accounts for only 53% of China's.

A familiar trend in developing economies offers some context: as national wealth increases, the share of consumption shifts from goods to services. As China follows in the footsteps of manufacturing giants like Germany *(Display 1)*, it faces the same limitations—a large, export-driven manufacturing base without a proportionate domestic market to absorb the production. Since the 1990s, Germany's manufacturing as a share of GDP has stabilized, yet its limited domestic goods consumption has led to a massive rise in net exports. China's economic trajectory is similarly export-dependent, which should accelerate trade surpluses and accentuate tensions with countries like the U.S. and those in Europe.

DISPLAY 1

Stabilizing Manufacturing Alongside Rising Exports in Germany

GDP shares by sectors (%)



Source: MSIM, Bloomberg, FactSet, Haver. As of September 30, 2024.

Trade and Capital Shifts: Exporting Influence, Losing Capital

TRADE FLOW CHANGES

Chinese shipments to the U.S. have dropped from 21% of its total exports in 2000 to 16% currently *(Display 2)*. Despite mounting trade tensions, particularly with the U.S., China has largely retained its global market share of 14% by redirecting exports to the EU and emerging markets (EM). Shipments to developing economies have surged from 16% of total exports in 2000, to 44% in 2023. Chinese products are increasingly replacing domestic manufacturing in developing economies, as well as imports from developed markets (DM).

Increased trade and investments have been the strategic direction of Beijing's external policies. On one hand, Chinese companies have relocated parts of their manufacturing outside its borders to circumvent tariffs. For example, ASEAN (Association of Southeast Asian Nations) countries process Chinese raw materials and re-export finished goods globally. On the other hand, import substitution efforts have reduced foreign input reliance for Chinese exports from 52% in 2004 to 20% in 2024. This shift has strengthened domestic supply chains in critical sectors such as semiconductors, batteries, EVs and solar panels. Lower-end manufacturing like textiles, apparel and furniture should continue to move to developing countries. Export diversification with China's 25% tariff on U.S. soybeans, beef, pork, wheat and corn has led to a pivot toward Brazil, Argentina, Ukraine and Australia.

CAPITAL OUTFLOW CHALLENGE:

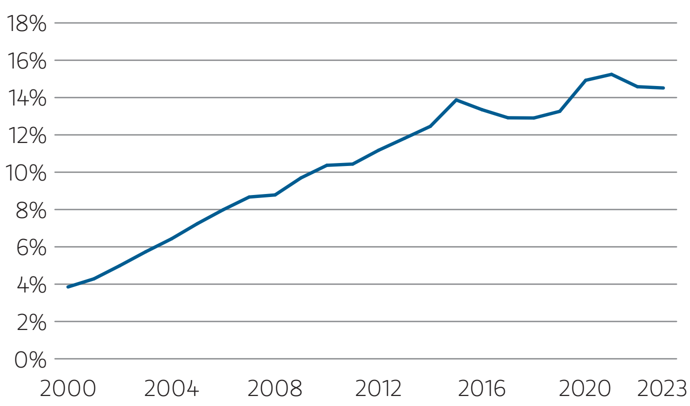
Since the beginning of 2022, China has experienced significant capital outflows of close to $300 billion and a 70% decline in foreign direct investment (FDI)—especially in strategic manufacturing industries such as semiconductors, telecommunications and pharmaceuticals—largely due to the U.S. and advanced Asian economies. This decline would have been even more substantial were it not for the increased investments from Germany and Singapore, highlighting the strategic focus of these nations on the Chinese market, particularly in the high-tech, automotive and green sectors.

China's outward FDI is increasingly driven by geopolitical factors, market access and cost considerations. In 2022-23, the number of China's FDI projects in the U.S., Europe and advanced Asian economies declined substantially. In contrast, total flows to Mexico and Vietnam have more than doubled, as both countries serve as strategic gateways for Chinese businesses to navigate geopolitical constraints and cost pressures.

DISPLAY 2

China's Share in Global Exports Is Stable Despite Tariffs

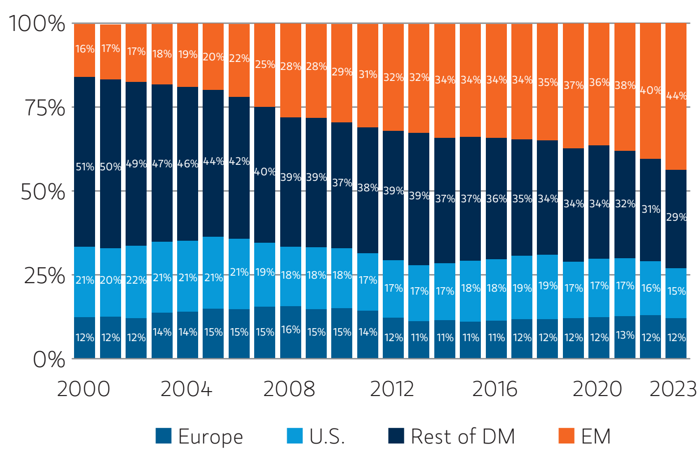
China's share of global exports (%)



Source: MSIM, Haver. As of December 31, 2023.

China Is Decoupling From the U.S., Redirecting Exports to Emerging Markets

China's export share by destination (%)



Source: MSIM, Haver. As of December 31, 2023.

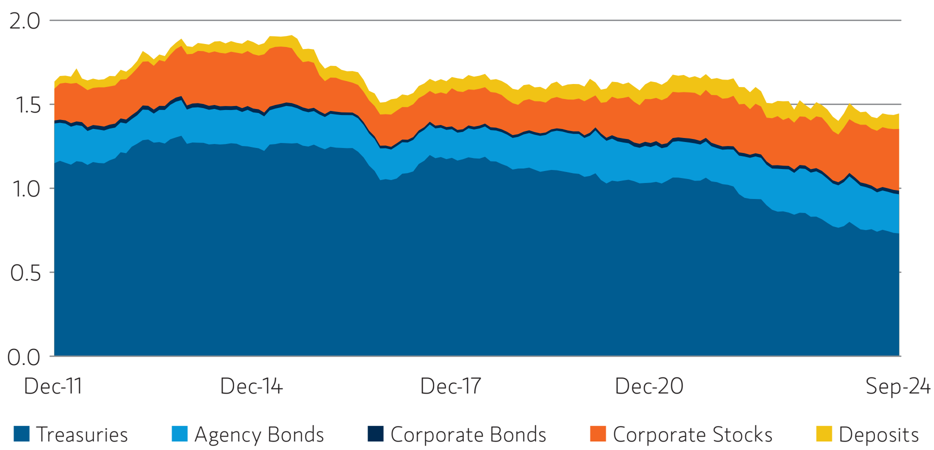
Recent moves by Beijing, from issuing a U.S. dollar bond in Saudi Arabia to imposing export restrictions on rare earth metals, indicate China could retaliate against tariff policies and build ties beyond trade with friendlier countries through financial channels.

The story with regard to portfolio flows is different. Interestingly, China's portfolio investments in the U.S. have remained relatively stable between 2016 and 2023 (*Display 3*). While there has been much hand-wringing over the decrease in Chinese treasury purchases, this has been largely offset by higher flows into agency bonds and corporate stocks. China remains the third largest investor in U.S. capital markets, following Japan and Canada.

DISPLAY 3

China's U.S. Investments: A Shift, Not a Retreat

China's Holdings of U.S. Assets (in trillions of USD)

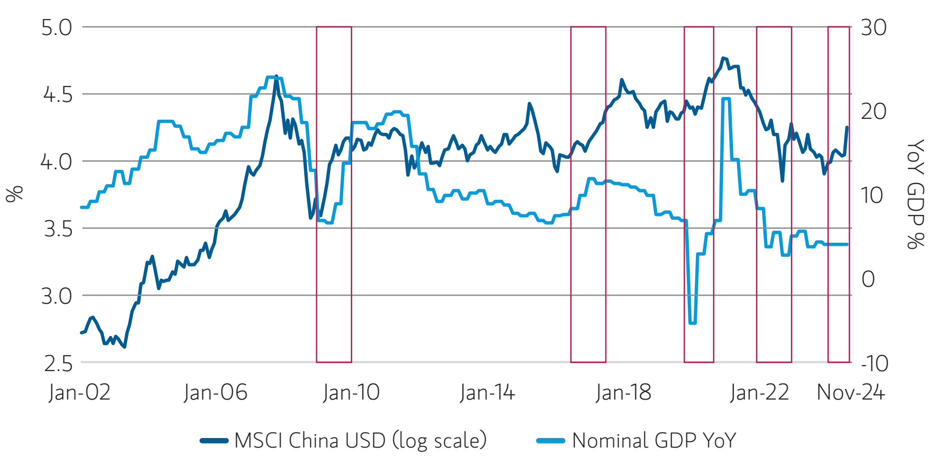


Source: MSIM, Haver, U.S. Department of Treasury. As of September 2024.

DISPLAY 4

China's Five Rounds of Stimulus Led to Five Equity Rallies, but No Breakouts

The impact of China's stimulus packages on nominal GDP and stock markets



Source: MSIM and EME research. As of November 30, 2024. The views and opinions expressed are those of the Emerging Markets Equity Team at the time of writing of this presentation and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass. **Past performance is no guarantee of future results.**

The Cyclical Nature of Stimulus: An Echo of Japan's "Lost Decade"

Since the Global Financial Crisis, China has rolled out five major stimulus packages, which have merely postponed an inevitable reckoning. China's latest round of stimulus, its fifth in 15 years, illustrates a recurring pattern of fiscal and monetary intervention that boosts growth temporarily (*Display 4*).

Historically, each stimulus has provided a short-term market lift but, as evidenced in the last cycle of 2022, such effects are beginning to wane. Japan's "Lost Decade" of the 1990s provides a sobering parallel.

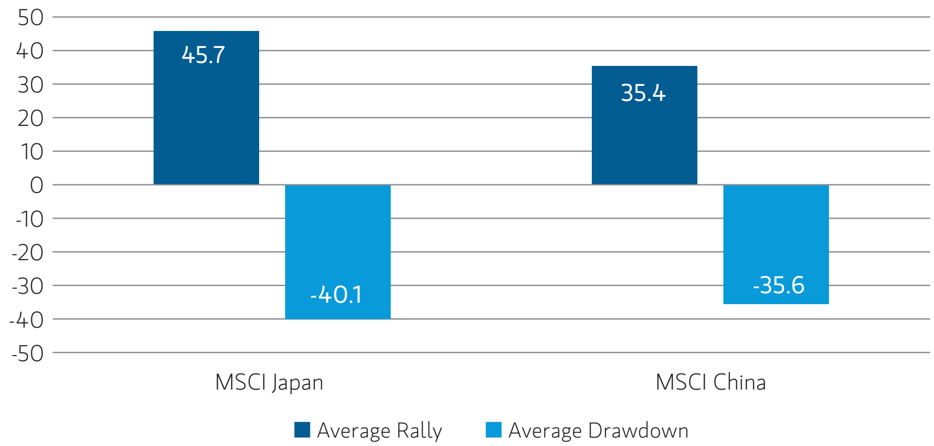
In most countries, monetary expansion causes inflationary pressure, as it increases demand relative to output. China's current condition bears similarities to Japan's in the 1990s, where the opposite occurred primarily in the way credit expansion fuels the supply side of the economy (production) rather than boosting the demand side (consumption). This resulted in output growth outpacing demand growth, causing deflation rather than inflation. In Japan, supply-side policies failed to drive both rebalancing and rapid growth. The consumption share of Japan's GDP bottomed out at 63.3% in 1991 (compared to 53.4% for China in 2023) and it took 17 years for the consumption share to rise by 10 percentage points. In 2008, it had reached 73.8%, still trailing the global average. During that time, Japan's share of global GDP dropped from 15% to 7.9%.

Following its economic peak in the 1980s, Japan experienced long-term stagnation interspersed with brief market rallies that averaged 45%. China's market, under the influence of stimulus packages, has similarly rallied five times in recent cycles by about 35% *(Display 5)*, making lower highs and lower lows in the downward trending market performance.

DISPLAY 5

China's Market Is Shadowing Japan's in the 1990s

Average rally and drawdown during larger downtrends, MSCI China and Japan



Source: MSIM, EME research, Bloomberg. As of October 16, 2024. The views and opinions expressed are those of the Emerging Markets Equity Team at the time of writing of this presentation and are subject to change at any time due to market, economic, or other conditions, and may not necessarily come to pass. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass. **Past performance is no guarantee of future results.**

The Path Forward: A Painful but Necessary Reset

Until China addresses the root issues—excessive debt and inefficient investment—stimulus measures will remain mere band-aids. While they temporarily inflate nominal growth and trigger short-term cyclical market rallies, stimulus measures will be incapable of providing a sustainable economic recovery or a stock market breakout.

There are no quick fixes to China's economic growth model. Exports continue to be its driver, as its stimulus packages have pushed production higher rather than consumption. Though it has been able to divert trade from the U.S. to the EU and EM, the overall reduction in capital inflows continues. The imbalances in China's economy have widened over the years, and only a complete debt restructuring and government-led income redistribution will drive positive change.

Lessons from other debt-laden economies suggest the path to stability requires cleaning up bad debt through write-offs or debt restructuring, followed by bank recapitalization. This approach is undeniably painful, as it acknowledges financial losses. But without such drastic measures, stimulus packages will continue to provide fleeting relief in markets, leaving the underlying structural weaknesses unaddressed. A deeper transformation must occur for China's lasting economic health.

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