

# Outlook 2023: A Cyclical Recovery

- 🌐 **China finetuning “COVID-Zero”; flames of “Dual Circulation” turning blue.** The Chinese authority is finetuning “COVID-0”, at a juncture when negative exports growth for the first time in 29 months and negative retail growth are suggesting receding demand both home and abroad. Yet onshore market rebounded strongly - from a similar level last seen at the onset of COVID in Mar 2020.

China’s export cycle, an intermediate economic cycle running every seven years, has peaked in Feb 2021, and has translated to slowing accumulation of current account surplus compared with GDP. The export cycle correlates closely with China’s stock market cycle via the liquidity created via its export cycle. Thus, a peaking export cycle argues against a “secular bull market” suggested by consensus.

- 🌐 **Economic cycle near turning point, but arduous property recovery likely.** The short cycle as measured by the property investment cycle, however, is nearing its turning point, but still needs a catalyst to initiate a new cycle *over the course of next twelve months*.

There are many similarities between now and early 2014. For instance, both periods saw Fed tightening and Chinese property struggling, and the authority eventually came to the rescue. There are also analogs in the market trajectories in both periods. For instance, the Shanghai Composite struggled in the first few months in 2014.

Meanwhile, the US short economic cycle is receding from its peak, but not yet appropriately reflecting the recessionary risks confronting the US economy. Given the intertwining of the US and Chinese economies, US macro volatility will find its way to Chinese markets and onto the world via exchange rate, commodities, stocks, and bonds.

- 🌐 **Shanghai ~3-3,500, Hang Seng ~16-23,000, with bouts of volatility. Easing into Cyclical/Growth over Defensive/Value.** Our base case is that China will reopen gradually with zigzags, its property sector will recover slowly with policy support, and a 2023 US recession. If any of these three uncertainties is better than expected, such as faster reopening, swift property recovery or no US recession, it will add to our base-case payoff.

China margin cycle is re-expanding and bodes well for the relative performance of cyclical and growth over defensive and value. Intuitively, if China reopens and property recovers, cyclical demand should improve. And growth, too.

Of course, the risk is China stays a hermit, property continues to ail, and a US recession. Such triple whammies would render a risk scenario similar to what we have been through in 2022 – no need to elaborate further. Even so, the epic volatility in 2022 suggests that we should have seen some of the lowest points in the Shanghai Composite and the Hang Seng Index in the current cycle.

It is time to look forward.

Hao Hong, CFA  
[hao.hong@growim.com](mailto:hao.hong@growim.com)

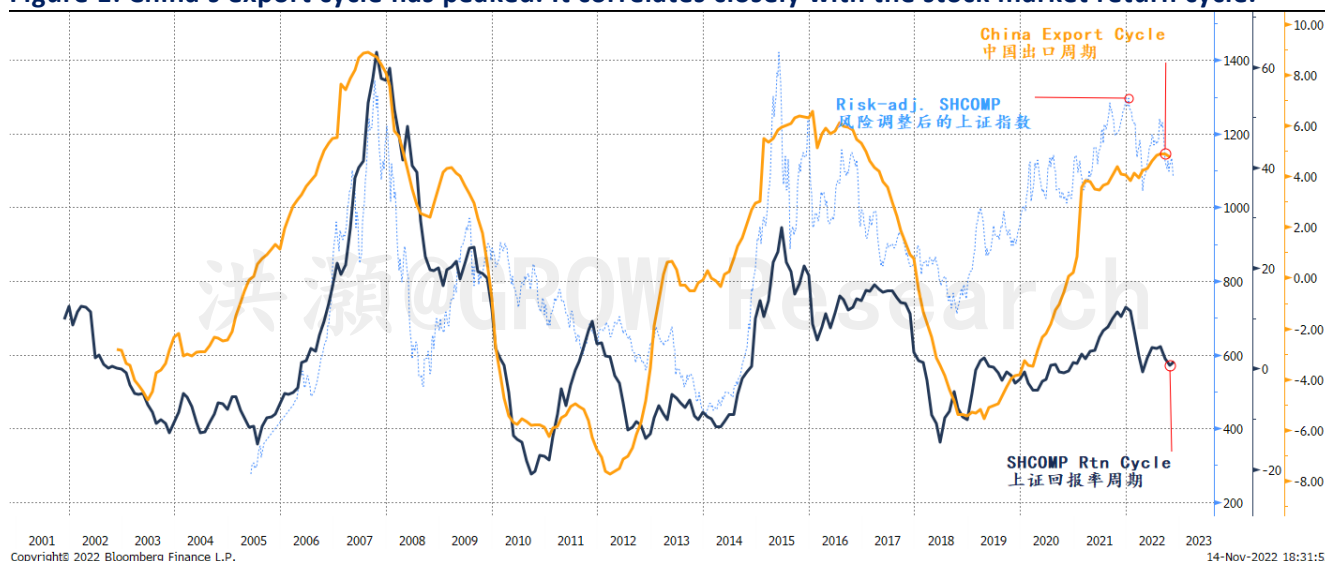
Chinese version:  
《“展望 2023：或跃在渊”》

## “Dual Circulation” Need Re-starting

On Oct 31, 2022, we published a report titled “***Mai! Mai! Mai!***”. We wrote that “*at this point, excessive pessimism doesn’t help anyone and starts to disagree with our contrarian-self*”. It is a change to our cautious stance on Chinese markets issued twelve months ago.

Since our report three weeks ago, both on- and off-shore markets surged to some of their best gains ever, adding well over 4 trillion yuan worth of market cap. Our follow-up tweet on Nov 1 was kindly dubbed the “***Trillion-Dollar Tweet***”. All these tectonic shifts suggest reopening is key, and it is coming.

**Figure 1: China’s export cycle has peaked. It correlates closely with the stock market return cycle.**



There is much to cheer about. But amid all the market hysteria, one must sit back to gauge the sustainability of such resurgence. After all, a technical rebound can be strong but fleeting, but a bull market needs more than a sentiment change to sustain valuation expansion. Without improving fundamentals that will support sustainable earnings growth, investing will once again turn into a game of cutting your trading opponent’s lunch, rather than sharing a growing pie.

To us, China starts gradually adjusting COVID measures at this juncture is not without reasons. China’s export growth has turned negative in October for the first time in 29 months. That is, external demand, one prong of China’s “Dual Circulation” strategy, is starting to fail. In the past two years, China’s economy has remained resilient, owing to the strength in Chinese exports that confounded most economists, despite COVID-0 and a frail property market. But the table has begun to turn. And the Fed’s tightening has started to affect demand for Chinese exports.

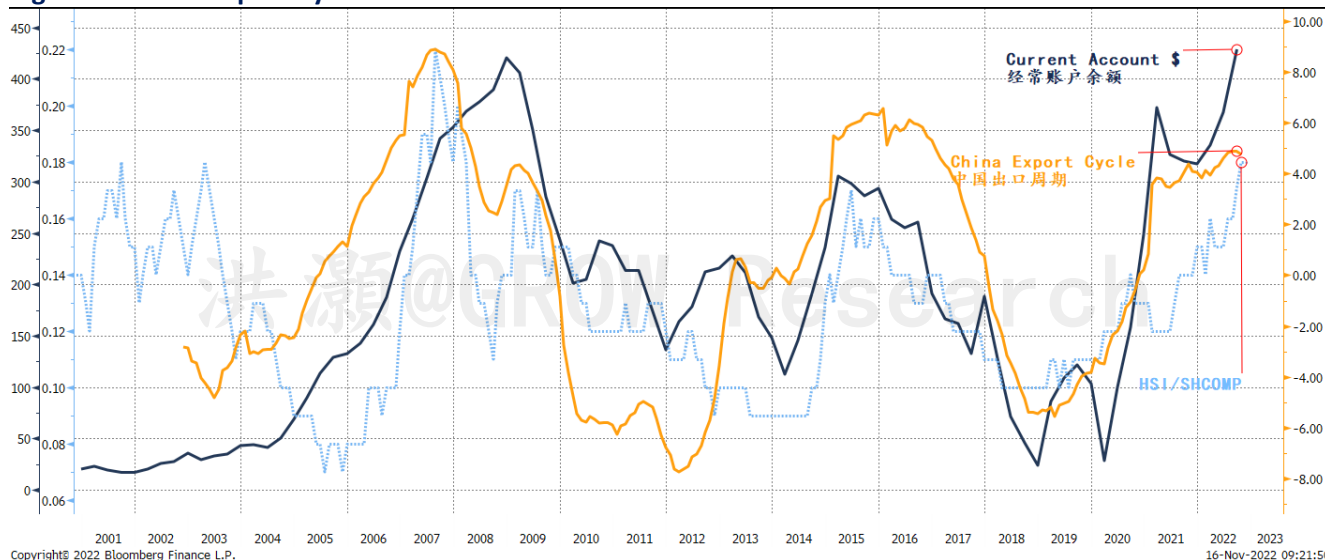
Meanwhile, retail sales growth, a measure of domestic demand, has also slipped into negative territory in October. As such, both wheels of “Dual Circulation” begin to get stuck in reverse. If exports, consumption and investments would not support the economy, while government spending would be strained by declining land sales, the outlook for 2023 would appear bleak.

To resist such gloom, it is time for China to reopen.

We can show that China’s export growth, after adjusted for a 3.5-year cycle, is closely correlated with China’s stock market return cycle (**Figure 1**). It also ebbs and rises with China’s current account balance, as well as the relative return between the Hang Seng Index and the Shanghai Composite (**Figure 2**).

The peaks of China’s export cycle are 2008 and 2015, the years when China saw the two infamous bubbles in its stock market history (**Figure 2**). This is no coincidence, as forex funds have been an important source of China’s domestic liquidity, and current account accumulation from the export cycle has become part of the country’s money supply to drive China’s stock market. In early 2022, China’s export cycle has once again peaked. It is the argument supporting our cautious and contrarian stance in 2022, and a profound explanation for China’s dismal stock market performance this year.

**Figure 2: China export cycle moves in tandem with current account and HK’s relative return.**



As we wrote, China’s on- and offshore markets soared, and consensus started to chant “the start of a new secular bull market” again. While we share some of the optimism, the above discussions about the peaking of China’s export cycle and its correlation with China’s stock market return cycle offer contradicting evidence to such claims.

That said, China’s export cycle runs about every seven years, but our outlook is about the next twelve months. While the consensus’s claim about a new secular bull market lacks fundamentals, shorter-term cyclical moves can still counter a longer-term falling trend.

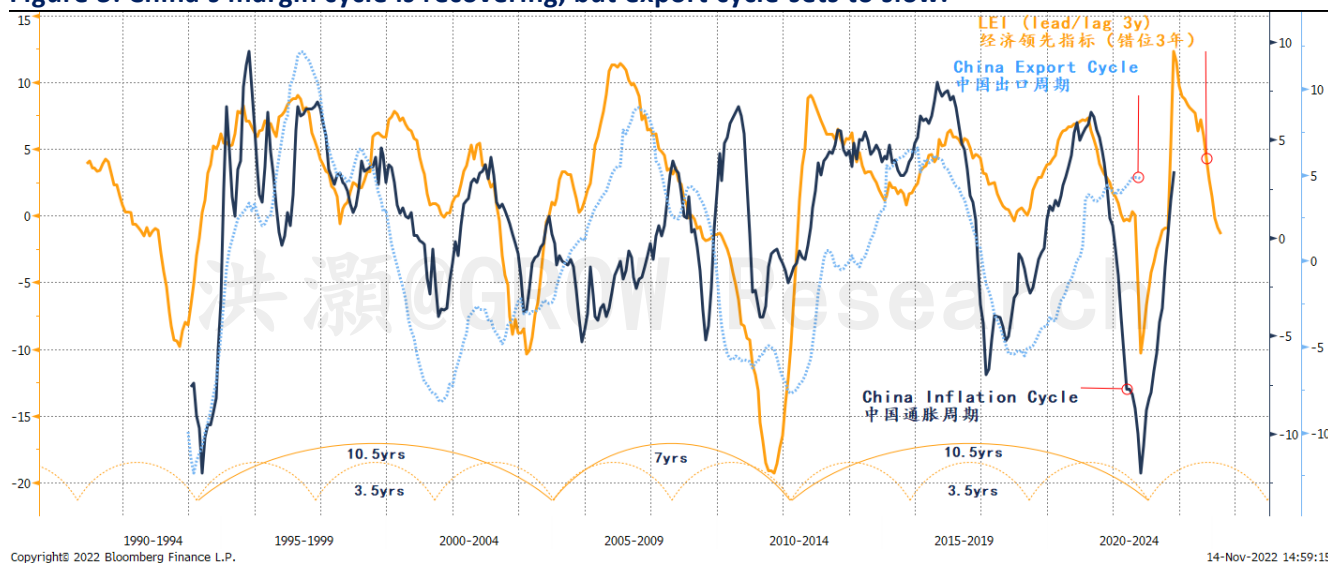
## China's Short Economic Cycle Near Turning Point. But...

Many cycles run concurrently within an economy. The margin cycle is one of them. We measure the margin cycle by the gap between CPI and PPI. We can show that China's margin cycle is closely correlated with the export cycle and leads the global economic cycle (**Figure 3**).

As data show, China's margin cycle is expanding. It is because of rapidly falling upstream prices, rather than the rising pricing power in the downstream. Expanding margin gives incentive to produce, while weak demand for goods will eventually lead to inventory buildup – if China continues to unswervingly stick to “COVID-0” despite falling foreign and domestic demand. Thus, the Chinese economy will soon enter the destocking phase that will drag on growth.

Meanwhile, the leading indicator for the world economy has declined sharply, but still not at a level appropriately reflect the challenges that the world is facing (**Figure 3**). As such, when China starts to destock in the coming months, the world economy will likely be affected further. And both prongs of “Dual Circulation” will hurt.

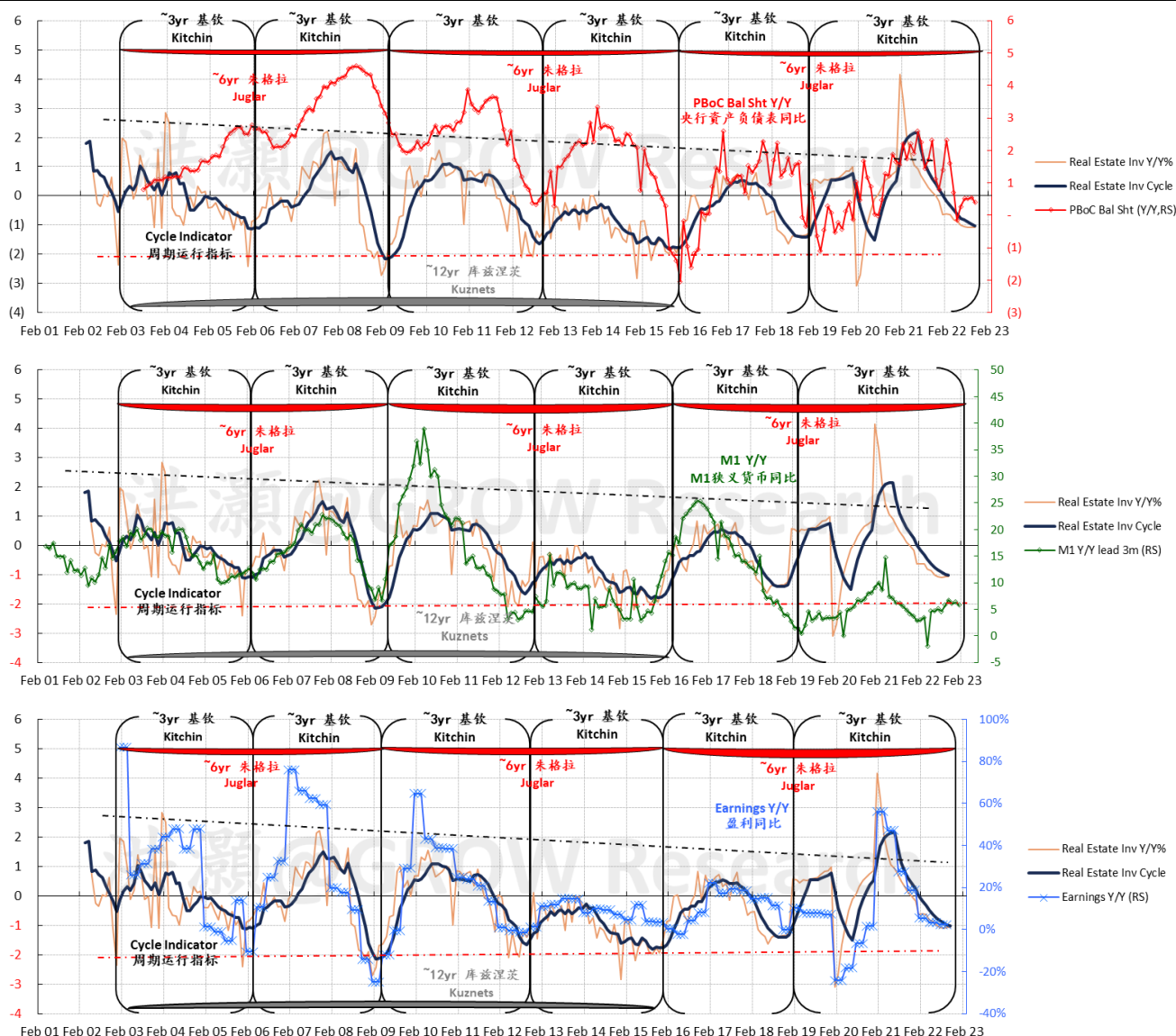
**Figure 3: China's margin cycle is recovering, but export cycle sets to slow.**



Our proprietary model also suggests that China's property cycle is nearing its turning point (**Figure 4**). China's property cycle is closely correlated with almost all macroeconomic variables and thus can explain the bulk of variance in the Chinese economy. For instance, the property cycle moves in tandem with rebar, bond yield, stock market indices, CNY exchange rate, money supply growth, the PBoC's balance sheet and so on (**Appendix 1-4**).

The property cycle runs every three to four years. If the current cycle started in early 2019, although punctured by the pandemic in 2020, by now the property cycle should be close to the beginning of a new cycle, if history is a guide (**Figure 4**).

Figure 4: China economic cycle nearing a turning point.



Source: Bloomberg, GROW Research

However, just because a cycle is nearing its turning point doesn't not necessarily mean that the cycle will just turn by itself. As we always say, economic cycle is not an alarm clock. It approximates how the economy rises and falls through cycles. Necessary ingredients, such as credit, must be present for the property cycle to turn.

2022 has been a horrendous year for Chinese developers. As sales slow, cash flow is not able to cover all development needs. Some building projects are not finished and need the financial assistance from the government. Offshore USD developer bonds plunged 70%, due to some high-profile defaults.

We estimate that 2023 will see over one trillion yuan on- and off-shore property bonds maturing. For the first three quarters of 2022, the top 16 developers generated ~150 billion yuan of EBITDA, a proxy of gross cashflow. If we assume that 2023 sales won't recover quickly, and gross cashflow of the industry to be ~400 billion yuan, then developers will find it difficult to repay over one trillion yuan of debt due, without further assistance from the government.

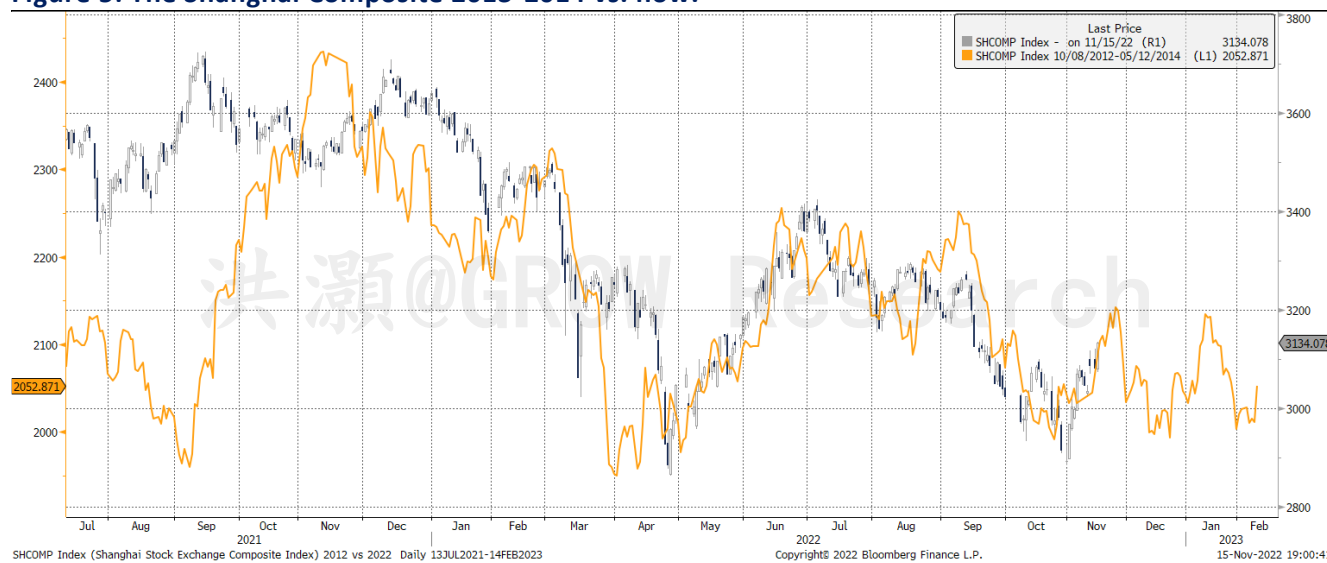
Fortunately, the government has announced the expansion of credit lines from 160 billion yuan to 250 billion yuan. Previously, this line of credit excludes developers. Further, there is guidance for the commercial banks to lend to developers. And the limits on the proportion of bank loan exposure to developers have been eased. While the extent of assistance that developers will need in 2023 depends on the recovery of property sales, this flurry of government easing measures hints at finetuning of property policy from the top.

Will it bend?

## 2013-2014 vs. Now

There are analogs between 2013-2014 and now (**Figure 5**). Such fractal resemblances in market trajectories, although could be pure happenstance, can offer some clues as to how the market reflects the confluences of significant events and changes in economic fundamentals in the months ahead.

**Figure 5: The Shanghai Composite 2013-2014 vs. now.**



Source: Bloomberg, GROW Research

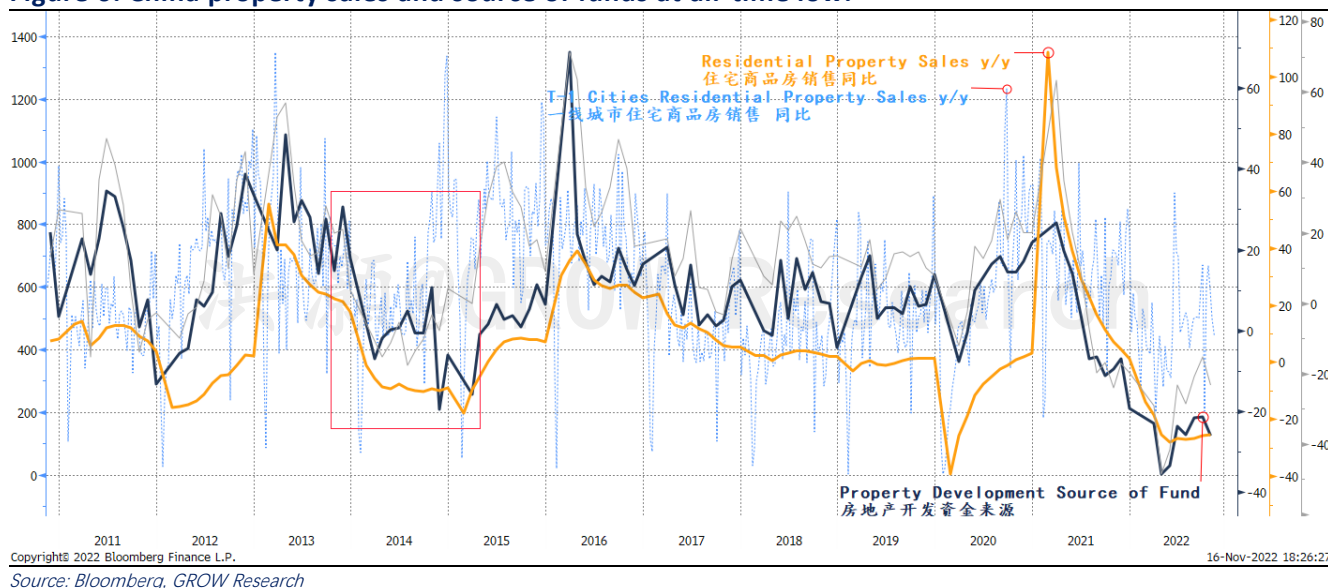
In Sep 2012, the Fed announced QE3 without a specific end date. QE3 expanded in Dec 2012, but Bernanke announced “tapering” of QE in June 2013 and started to taper in Jan 2014. By Oct 2014, bond buying had completely stopped. Such hawkish change to the Fed’s monetary stance, as well as subsequent maneuvers, is similar to what we have been witnessing in 2022.



Meanwhile, Chinese property sales slipped in early 2014, due to the restrictive measures taken in 2013 to curb property speculation. Then, the “9-30 New Policy” (“930 新政”) cut the down payment requirement and mortgage rate. It also relaxed some purchasing restrictions such as letting people who owned more than one property to buy if the mortgage on the first property had been paid off.

Even with increasing policy support, property sales took an entire year of 2014 recover. In August 2014, property inventory-to-sales ratio was as high as 38 months. It wasn’t until the interest rate and RRR cuts in 2015, coupled with policies on shanty town reconstruction by PSL expansion of the CDB, then property sales started to recover (Figure 6).

**Figure 6: China property sales and source of funds at all-time low.**



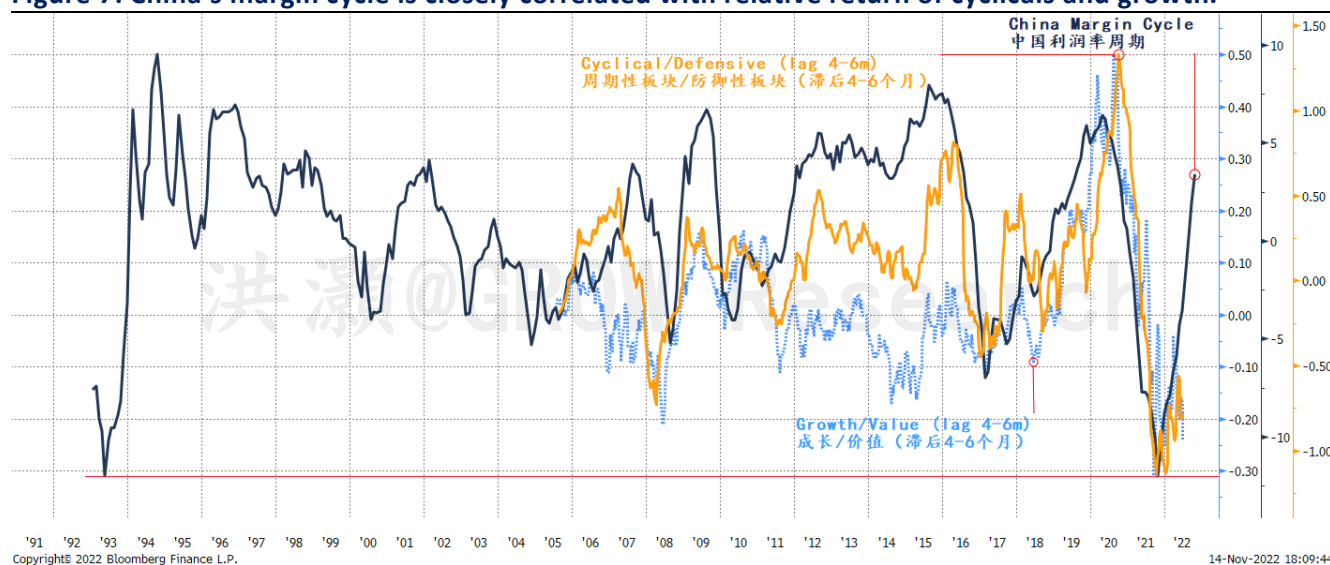
In sum, both the Fed’s policy and China’s property measures are similar between 2013-2014 and now. They are the two most consequential central banks in the world. That said, property sales and source of funds for property development in China now are even worse than they were in 2014. In 2014, it took much more than a few RRR and interest rate cuts, as well as the expansion of a policy bank, for Chinese property to recover.

In the first few months of 2014, Chinese stocks didn’t go anywhere, although with intermittent technical rebounds (Figure 5). If 2023 is similar to 2013-2014, stocks will be tested again in the coming months.

## Will Cyclical/Growth Outperform Please?

We have discussed in previous section that China's margin cycle, as measured by CPI-PPI, is expanding again. Interestingly, the nadir of the current margin cycle levels with the lowest point in history in the 1993 cycle (**Figure 7**). When margin is expanding, downstream demand will send more orders to upstream, and upstream will produce more to fill the orders. Eventually, margin expansion will induce an upstream recovery, and thus a potential upturn of the economic cycle.

**Figure 7: China's margin cycle is closely correlated with relative return of cyclicals and growth.**



If so, cyclical sectors, such as industrials, materials, discretionary, property and infotech, should outperform. Or their underperformance should narrow. We constructed an equal-weighted index of the cyclical sectors and compared its relative performance with the margin cycle. We can show that they are closely correlated, with the relative performance of cyclicals lagging by about four to six months. And the relative performance of growth sectors shows a similar relationship (**Figure 6**). These results confirm our theory of economic cycle.

While the margin cycle bodes well for the outlook of cyclicals and growth, there is an important caveat. Note that cyclical sectors include property and infotech, two key drags on the overall market performance in 2022.

The ills of property stem from developers over leveraging and plunging property sales. The malaises of infotech are from excess valuation bubble two years ago that is still being digested, as well as the US ADR audit. As such, while the margin cycle favors these sectors, they still need a lot of work and are fraught with risks.

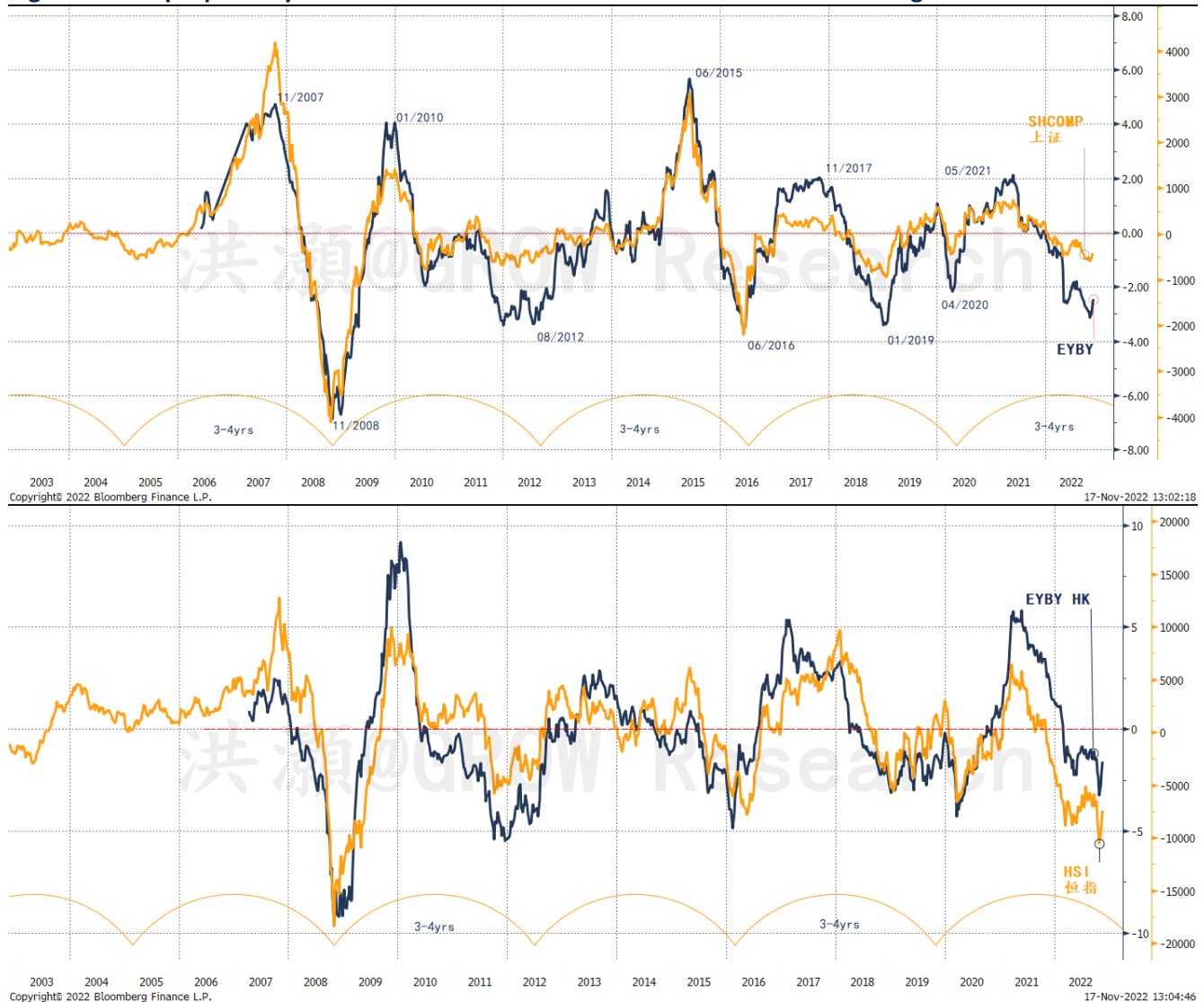


## Market Outlook

Our proprietary EYBY model that tracks China's economic short cycle of every three to four years is around its cyclical bottom, consistent with the observations from our economic cycle model based on the property cycle (**Figure 8**).

Our EYBY model for the Shanghai Composite forecasts a trading range for the next twelve months to be around 3,000 to ~3,500. For the Hang Seng Index, our EYBY model indicates that the ~15,000 level that we witnessed during the brutal selloff in late October should be a low point of the current cycle, with an upper bound of ~23,000. That said, we emphasize this is a very broad range, and its path will be treacherous.

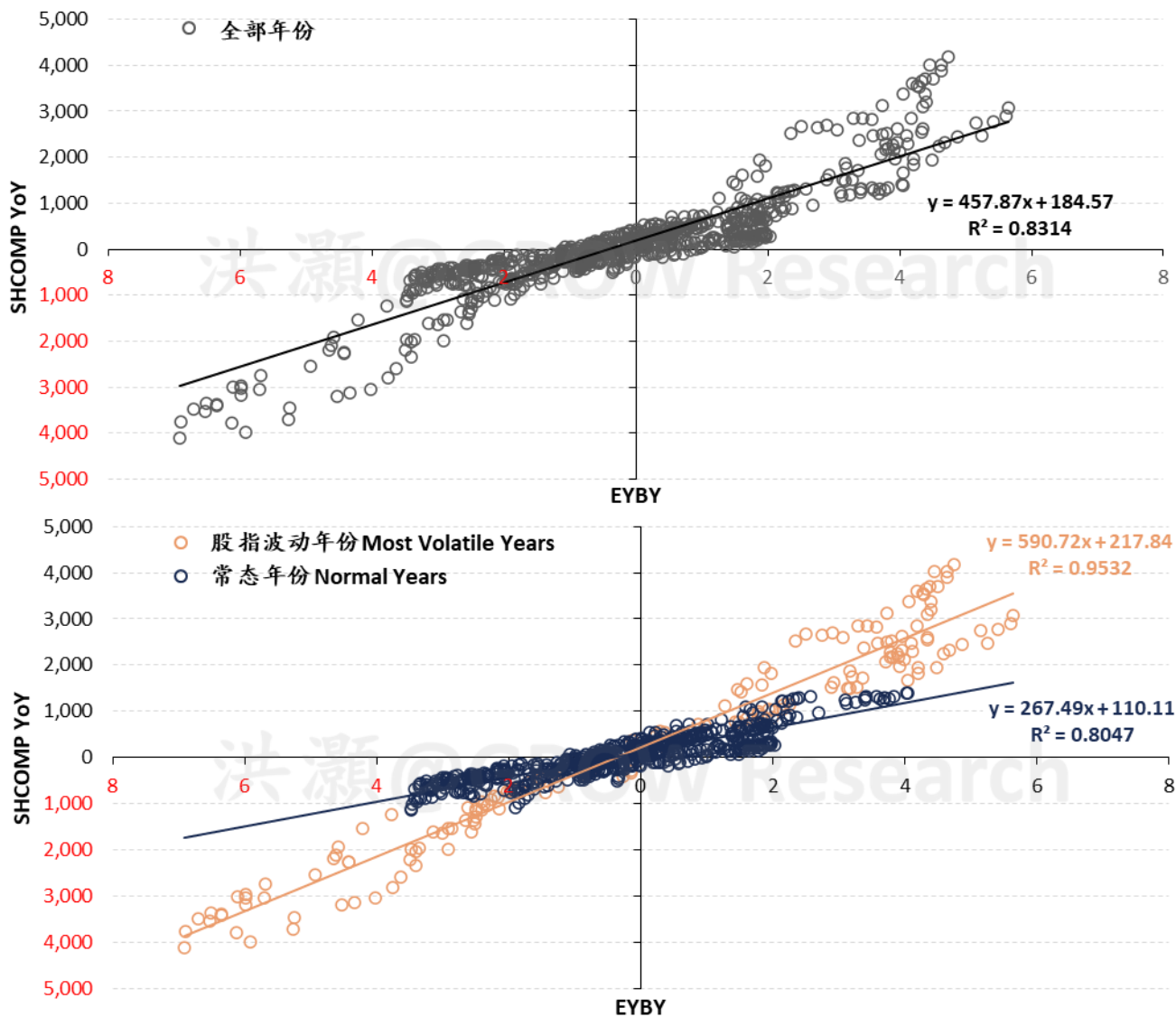
**Figure 8: Our proprietary EYBY models for on- and off-shore market are nearing its bottom.**



Source: Bloomberg, GROW Research

Our EYBY model correlates very closely with the underlying index, especially after adjusting for the bubble years of 2007 and 2015 (**Figure 9**). For instance, our forecast trading range for the Shanghai Composite, which was published in November 2021 for the twelve months to November 2022, was slightly below 3,000 to no higher than 3,800. Importantly, it was a lone voice for caution against the bullish consensus at that time and invited censorship scrutiny.

**Figure 9: Our EYBY model correlates closely with the actual index movements.**

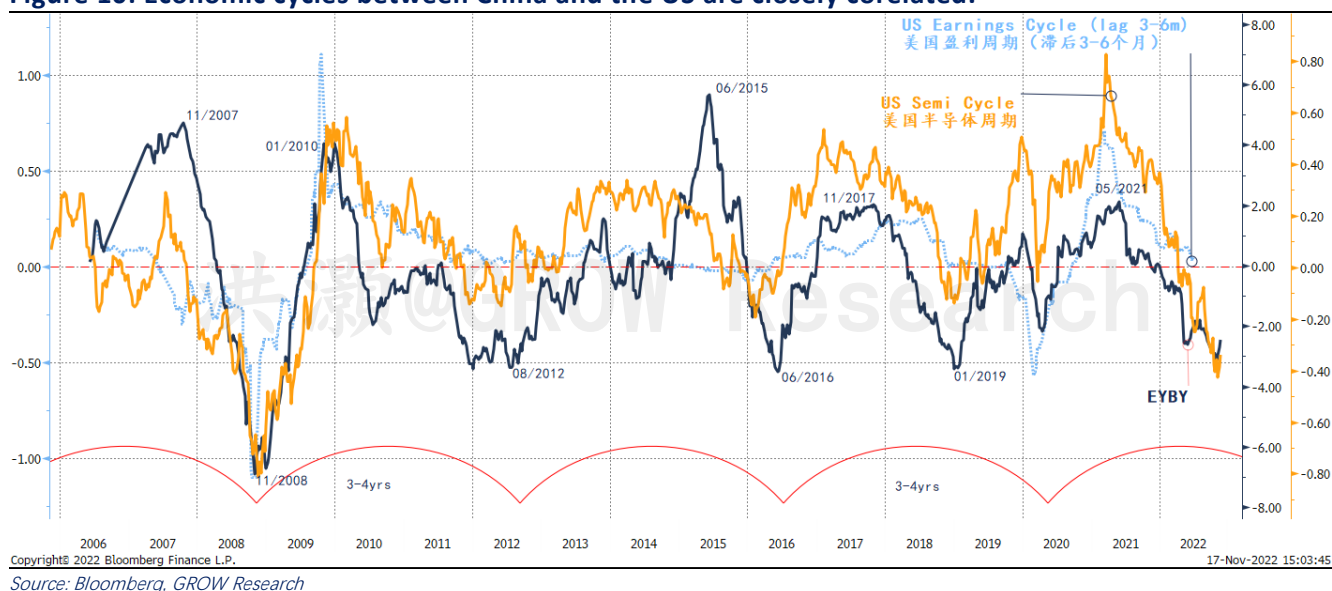


Source: Bloomberg, GROW Research

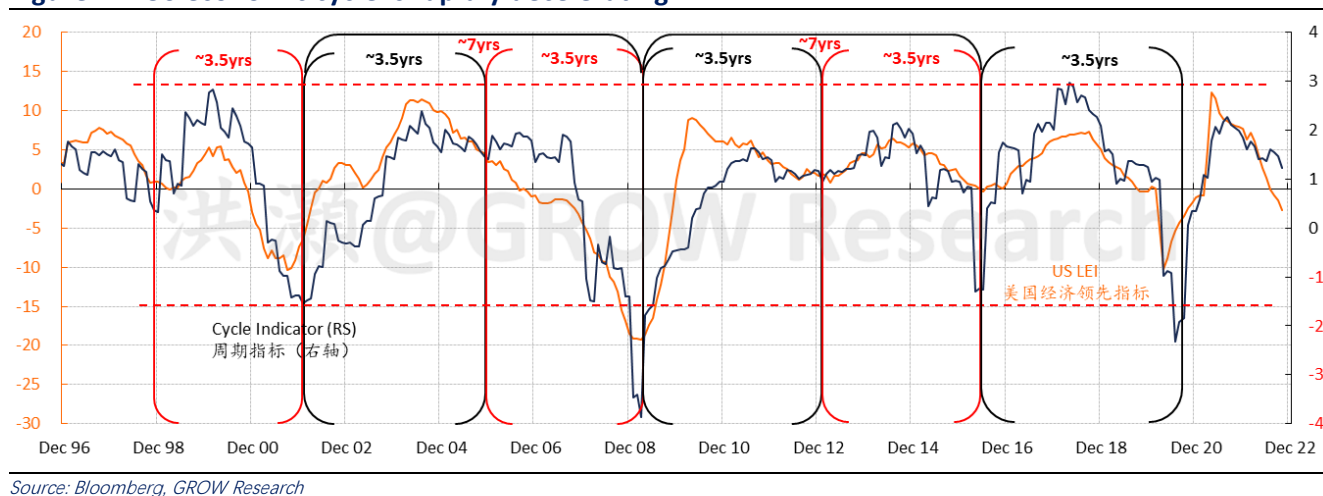
## Risks to Our Forecast

Our base-case forecast scenario is for a gradual reopening, a slow recovery in the property sector and a US recession in 2023, which will affect the return in Chinese stocks, especially the return of the Hong Kong and the offshore market.

**Figure 10: Economic cycles between China and the US are closely correlated.**



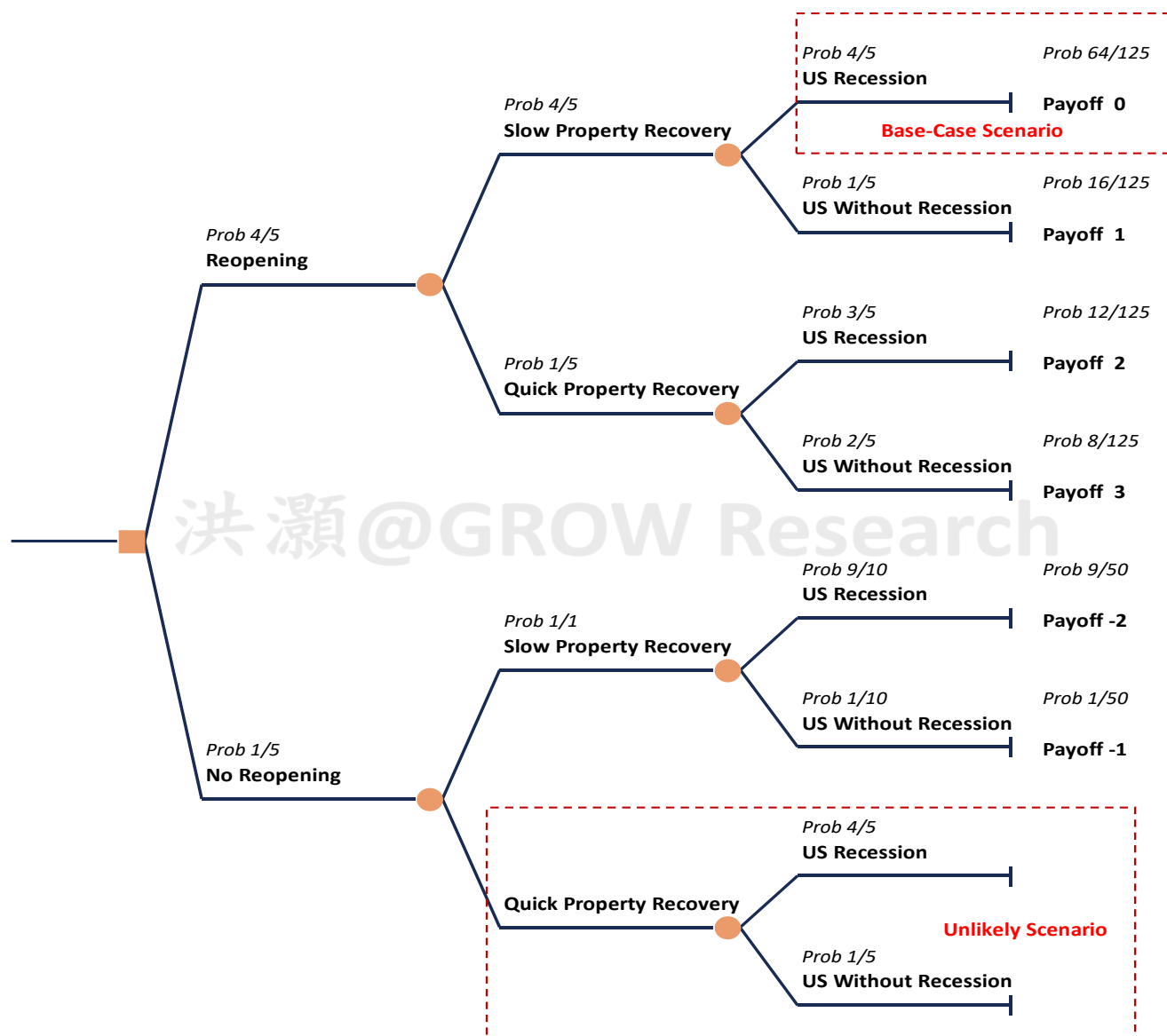
**Figure 11: US economic cycle is rapidly decelerating.**



Interestingly, our EYBY model can be also applied to the US economic cycle. In **Figure 10**, we can show that our model is very closely correlated with the US earnings cycle and the semiconductor cycle. Given the interconnection between the two economies, this observation should not have come as a surprise.

While the Chinese short economic cycle, as measured here by our EYBY model, is near its turning point, the US earning cycle has not yet, though it is rapidly decelerating (Figure 11).

**Figure 12: Scenarios in 2023**



Source: GROW Research

To facilitate our discussion, we have outlined the scenarios for 2023 in **Figure 12**.

There are many uncertainties affecting the investment outcome. The most important ones are: 1) whether China will reopen, 2) how fast Chinese property can recover and 3) whether the US will face a recession.

We have discussed the first two uncertainties in details in the above sections. We believe China will reopen and may already in the process. The reopening will be gradual and managed, fitting to the Chinese philosophy of gradualism. And there will be rounds of back and forth, as China “crosses the river while feeling the stones”. Despite the mounting challenges, it is not a question of whether China will reopen, but a question of over how long a period and how best to manage to minimize healthcare costs and potential lives lost.

Of course, the probability of reopening cannot be quantified, and must be monitored through propaganda nuances and gradation of local pandemic maneuvers. That said, we note that the rally started on Oct 31, 2022 around the level when the onshore stock market indices were around their lows seen in Mar 2020, the onset of COVID. As such, we assign a probability of 4/5 to the gradual reopening scenario. (This probability is a judgement call, and only shows how comfortable we are with the scenario.)

Another uncertainty is how the property sector will recover. We have seen the “*three arrows*” of policy support, such as supporting bond issuance by developers, guidance for the banks to lend to the sector and even potential participation in the equity issuance of developers.

Even so, a comparison between now and the situation of the property sector in 2014 suggests that the recovery will be slow rather than quick. In 2014, it took a few rate cuts and RRR cuts, as well as the re-expansion of a policy bank’s balance sheet to clear the property inventory accumulated from the “*Five National Measures* 国五条” of property curbs. As such, we assign a probability of 4/5 to the slow property recovery scenario.

Our proprietary economic cycle model, with strong track records, points to a looming US recession in the first half of 2023. As the Fed tightens, US demand will fall. US earnings growth, too. Thus, a gradual reopening, slow property recovery and a US recession in 2023 together set our base-case payoff.

If the outcome of any of these contingencies are better than expected, then payoff will be even higher. If not, significant market downside will ensue, with payoff below even our base case. Such risk scenario doesn’t need much elaboration.

We choose to fill our days with hopes, rather than to live in the shadow of fears.

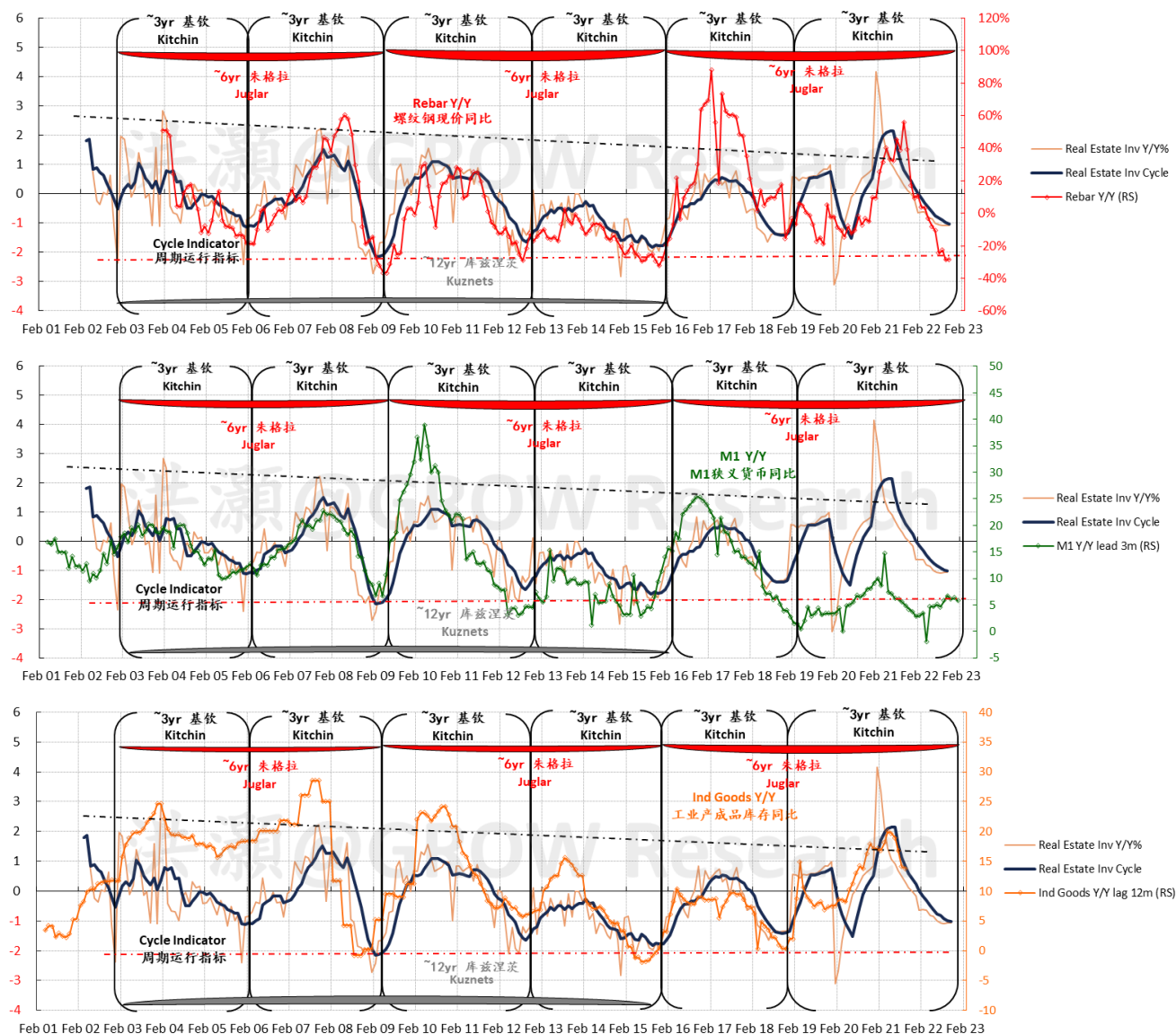
**Hao Hong, CFA**

**Twitter: @HAOHONG\_CFA**

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## Appendix

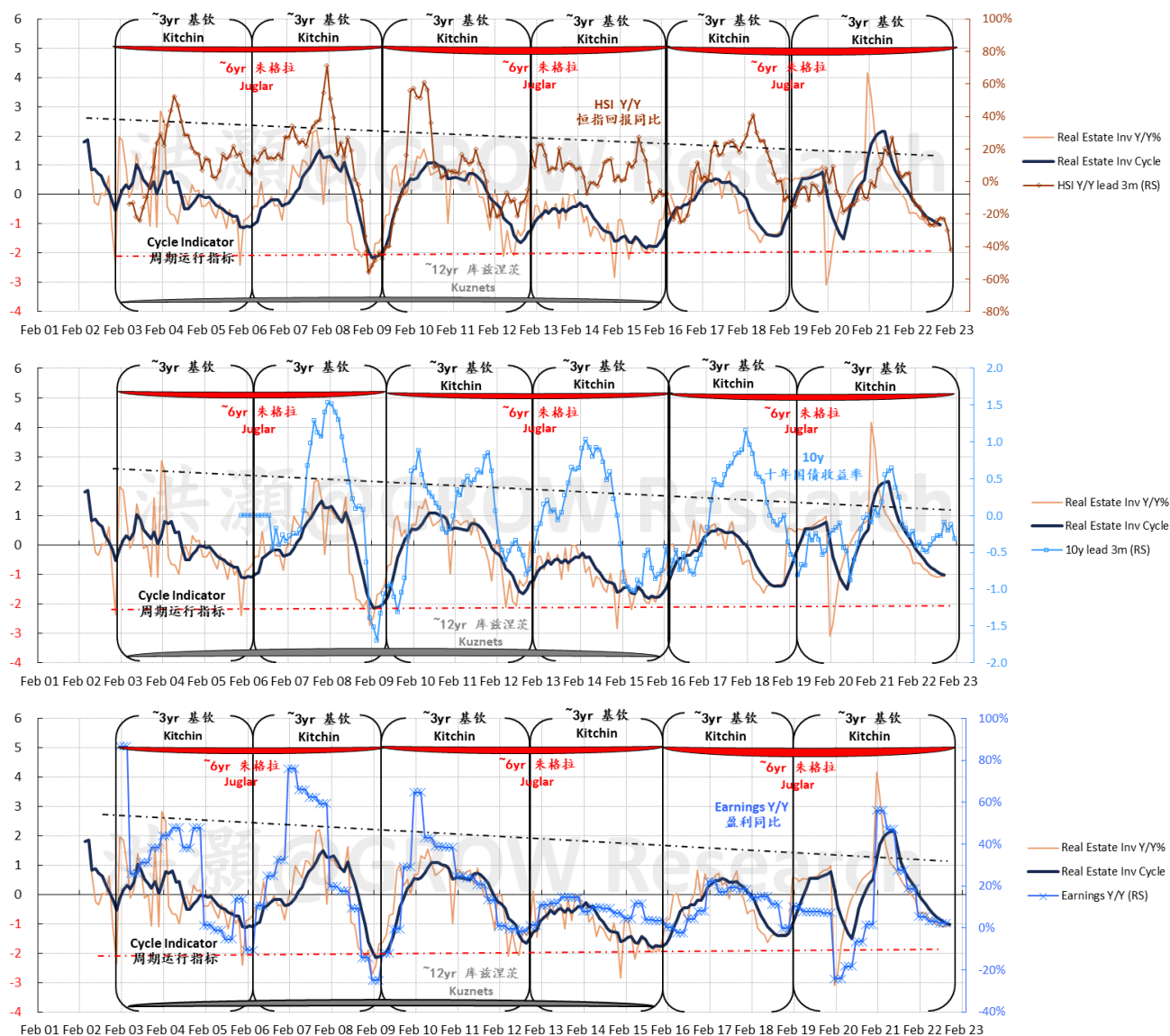
### Appendix 1: China economic cycle (1/4).



Source: Bloomberg, GROW Research

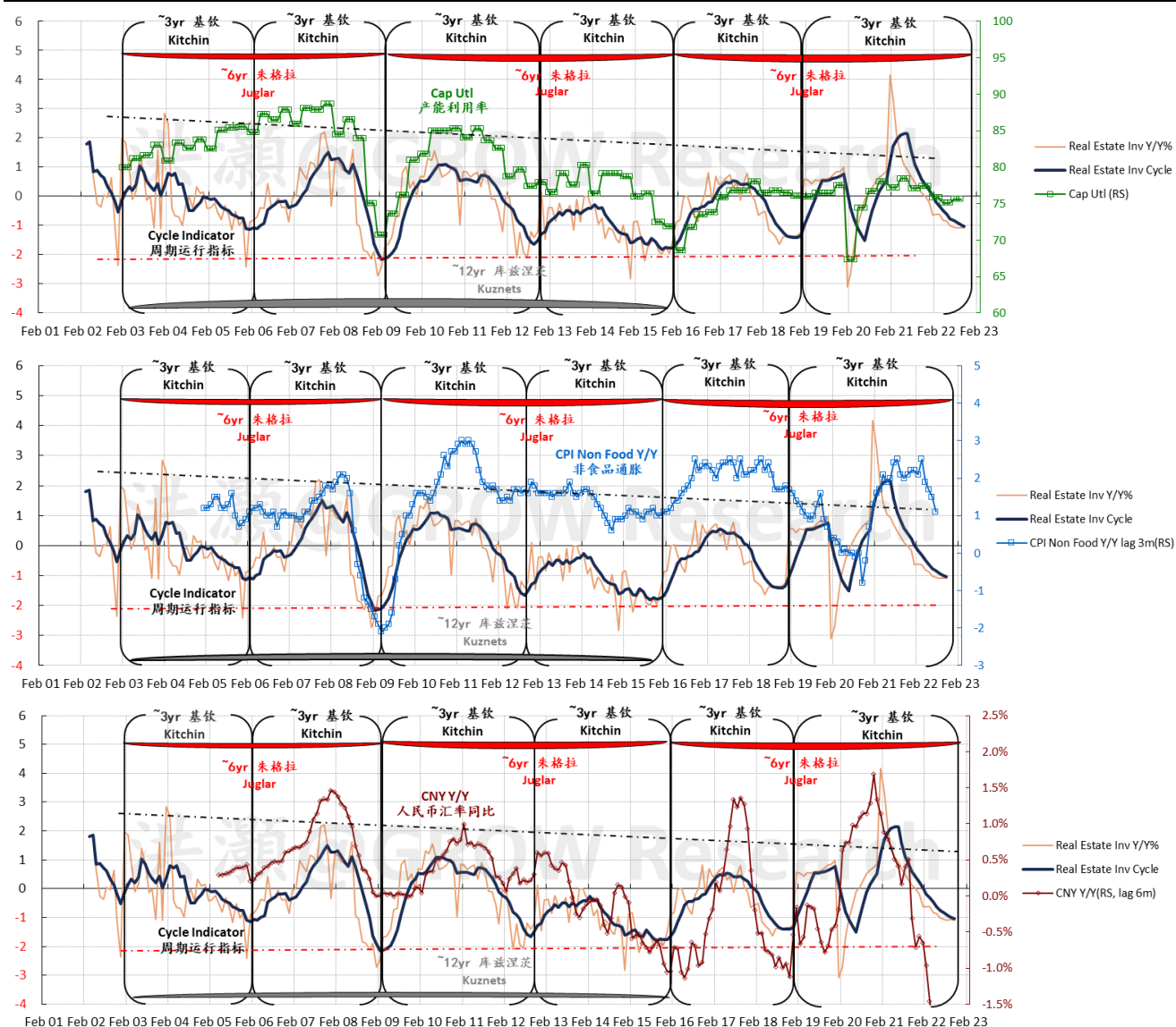


## Appendix 2: China economic cycle (2/4).



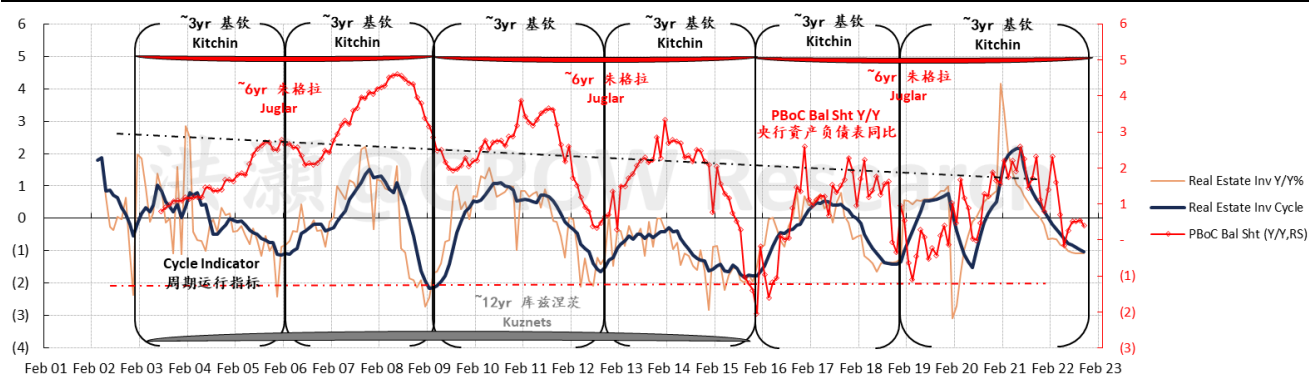
Source: Bloomberg, GROW Research

### Appendix 3: China economic cycle (3/4).



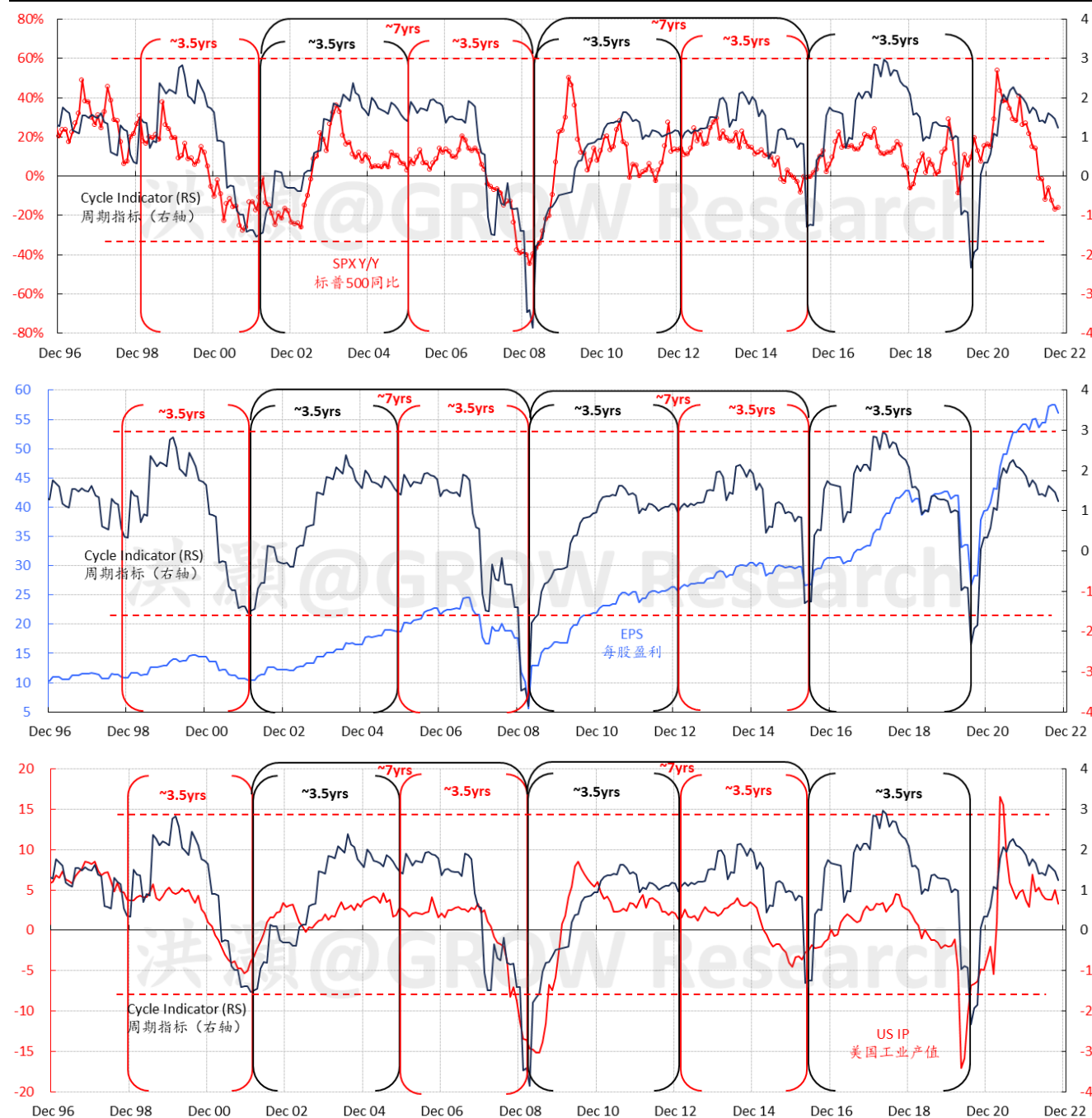
Source: Bloomberg, GROW Research

#### Appendix 4: China economic cycle (4/4).



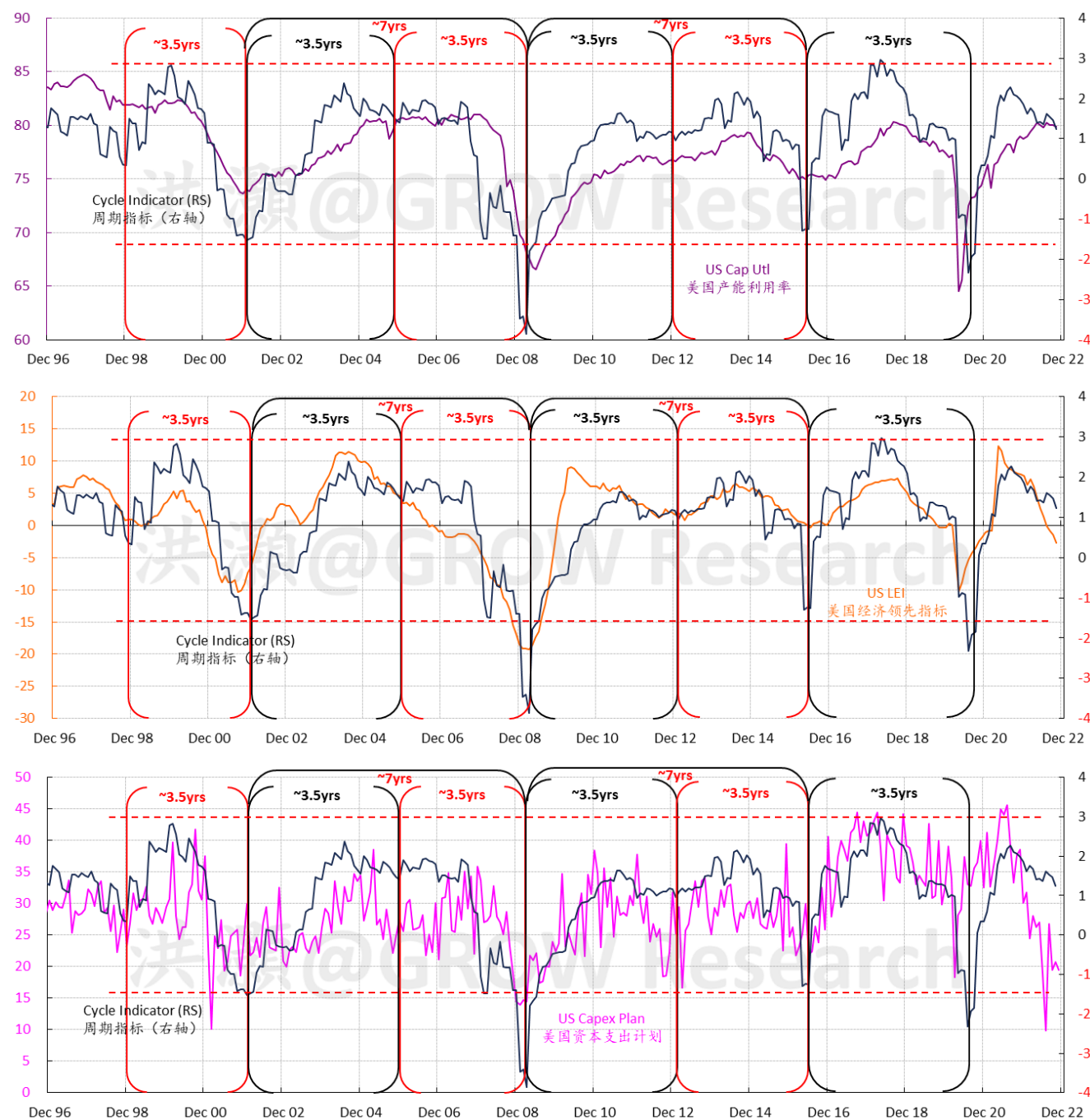
Source: Bloomberg, GROW Research

## Appendix 5: US economic cycle (1/3).



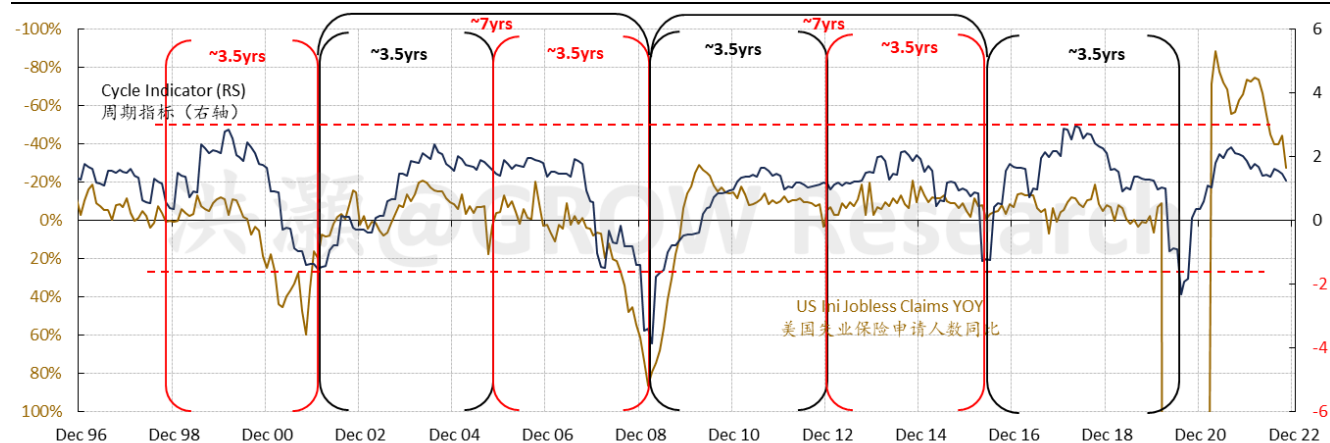
Source: Bloomberg, GROW Research

## Appendix 6: US economic cycle(2/3).



Source: Bloomberg, GROW Research

## Appendix 7: US economic cycle(3/3).



Source: Bloomberg, GROW Research

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