RBC Global Asset Management

Polina's Perspective
China: a pimple soup experience

July 2025

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"Despite the unappealing presentation and name, pimple soup was one of the best dishes I tried in China, reminding me of an English idiom: "don't judge a book by its cover"."

Have you tried pimple soup? I can wholly recommend it! I tried this local speciality for the first time a few weeks ago in the suburban town of Tianjin (close to Beijing), during my visit to China, where I was aiming to get a sense of the pace of economic and financial recovery.

Despite the unappealing presentation and name, pimple soup was one of the best dishes I tried in China, reminding me of an English idiom: "don't judge a book by its cover". In a world of uncertainty, where the US policy decision-making process is making investors' heads spin, China can always be relied on to provide a contrast when it comes to stability of the policy mix and a long-term horizon.

Sentiment-wise, not much has changed from a year ago. If anything, the implementation of salary cuts (I was told in some cases up to 70% at the beginning of this year) has had a further knock-on effect on consumer demand. An alcohol ban during business meals earlier in the spring has also had a 'sobering' effect.

Interestingly though, having visited a number of projects of troubled real estate developers, I observed a marked uptick in the pace of construction completion. However, there is a disconnect between sentiment and construction activity, and the explanation lies in profit distribution. Any proceeds from sold projects are channelled to SOE construction companies, not the developers. Not surprisingly, the latter continue to re-engage in several rounds of the negotiations with domestic and international creditors, but without much hope of financial upside for all parties involved.

From a return perspective, the property market in China is not an attractive proposition. In addition to uncertainty on the supply side, rental yields of 1-2% are well below the mortgage rates of 3-4%,[1] making this asset unappealing on the investment front. At the same time, the overcapacity challenge remains intact. In addition to weak consumer demand, the POE nature of the developers makes it more difficult for the government to implement administrative measures compared to a decade ago.

In 2015, when steel overcapacity was concentrated across SOE developers, the government could more effectively engineer sector consolidation. In fact, consolidation is now required in a large number of sectors, from banks to automakers, in order to improve profitability. With 150-200 automakers and over 4,300 banks in the system,[2] fierce competition continues to erode profitability. While the government is encouraging consolidation, progress has been slow.

[1] Centaline, UBS.
[2] National Financial Regulatory Administration.

Yet the government does not appear to be in a rush to provide another round of stimulus. There are several reasons behind this. Firstly, it is primarily focused on nominal GDP growth. The recently released Q2 2025 number of 5.3% year-on-year increase in GDP[3] was a positive surprise. Yet weakness in tax revenues, standing only at 13% of GDP compared to 15% a few years ago,[4] is testament to the fact that growth is being achieved at the expense of profitability.

While China has been subject to tariffs since 2018 and continues to navigate recent increases relatively well, additional tariffs ultimately contribute to the domestic deflation trend. I visited a few industrial plants and learned that, even with current tariffs, the export prices of certain goods are 5x cheaper than European or US-based alternatives. The biggest issue for industrial plants is domestic non-payment risk from their clients, with five-month delays becoming the new normal.

While the government is acknowledging the deflationary pressures, the sense of urgency to reverse the trend appears to be absent. It has introduced so-called 'anti-involution' (or anti-deflationary) measures that provide subsidies to select consumer goods, at a cost of 0.3% of GDP.[5] Yet it seems that more is required. In order to reverse deflationary trends, the government could also introduce floor prices to a large number of goods and, equally relevant, support the real estate sector by purchasing a significant share of the completed properties. Some experts estimate that a support package of at least CNY10 trillion (via special issuance bonds) is required, the equivalent of nearly 8% of GDP.

If fiscal support is rejected as a policy option, it appears to us that the PBOC might be under pressure to cut rates further. With CPI at negative 2%, one could argue that the neutral rate should be very close to zero compared to current deposit rates of close to 1%.

What does this mean for financial assets?

Despite weak economic activity, we could see continued outperformance of select financial assets in China. With deposit and policy rates trending lower, domestic investors in money markets are likely to look for investment alternatives but, with a closed capital account, Chinese savers have relatively limited options. While local government bonds have provided an attractive source of return over the last year – 10-year yields have rallied over 60bps to 1.65% – the equity market is becoming more attractive from a dividend yield perspective at 4-5%.[6]

Moreover, the absence of recovery in the real estate market and the lack of fiscal stimulus to facilitate this, combined with restrictions on investing above USD50k abroad, further narrows investment alternatives. In fixed income, Chinese authorities continue to put more effort into increasing foreign investor participation in the local sovereign bond market. Facilitating investors' entry in the local market through programmes such as Bond Connect further supports the government's longstanding goal of CNY internationalisation.

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That said, as of today, foreign investor exposure to the Chinese domestic sovereign bond market remains relatively limited at 3-4% of the total, with approximately 50% of this being central banks.[7] We could see the share of foreign players growing at a modest pace, given the need to diversify from the US dollar and the appeal of CNY's low volatility and valuation. The fact that consumers can buy an item such as an iPhone or a BYOD car in China at a 50% lower price than in Europe, without government subsidies, points to CNY cheapness.

We believe the Hong Kong local currency market could also be a key beneficiary of the current diversification trend. It offers investors a stable alternative to US dollar assets at a relatively attractive rate with a well-developed financial infrastructure. This could be an opportunity for Hong Kong authorities to develop a deeper local currency market for both sovereign and corporate issuers amidst a shrinking volume of US dollar denominated insurance.

It appears that China is determined to develop Hong Kong as a more influential global financial hub. Recently Chinese authorities allowed select domestic brokerage firms to facilitate crypto currency trading for their clients in Hong Kong. Nevertheless, domestic risk appetite remains relatively low when it comes to high yield assets, given the recent experience of real estate sector defaults. Authorities are looking for external agencies to provide guarantees in order to reduce the issuer credit risk for domestic investors. This ultimately provides a much stronger support for high quality names in the region and leaves high yielding issuers with relatively limited access to liquidity.

[3] National economy made steady improvement despite challenges in the first half year.
[4] China Finance 40.
[5] BNP Paribas.
[6] Bloomberg.
[7] China Central Depository and Clearing.

Another area where I noticed a visible improvement was the increase in environmental initiatives. Places that I visited only a year ago had transformed into green oases, with endless rows of trees planted along highways and urban districts. This is an example of 'green grass belt' under President Xi's slogan: "green mountains are as valuable as gold and silver". Improvements in energy efficiency are also notable in the manufacturing sector where, in addition to the dominance of electric vehicles with fully recyclable batteries, we were told that manufacturers now also deliver 3x better output for the same level of fuel used in their hybrid vehicle options.

Continued focus on innovation aided by the use of AI has spread across all sectors from manufacturing to consumer goods. I was impressed by new models of AI self-learning computers for children and the instant business transaction devices that we used in all our meetings. I couldn't resist buying an AI translation pen for my daughter who is studying Chinese, although generating the level of persistence and intensity fostered amongst her Chinese peers would be a separate challenge!

I continue to be fascinated by the Chinese work ethic. I was struck by the emphasis on 'self-criticism' practiced at senior levels of organisations. The CEO of one asset management firm shared with us that every year at the board meeting, she and her colleagues are expected to highlight their own individual areas of weakness and demonstrate commitment to improving them over the coming period.

Even in leisure activities, the Chinese strive for perfection. A few senior business owners highlighted that they and their children exercise seven days a week. I was cited an example of an eight-year-old boy who plays tennis for four hours every day, and this is viewed as the norm, not an exception. One can't help but notice that the level of intensity could easily slip towards 'overdoing' things, with potentially damaging consequences. Not very long ago, President Xi banned after-school tuition in an effort to tackle involution, though this move has given a boost to AI-based learning computers for children as a replacement for this tuition.

The Chinese way of living and working might not appeal to Western audiences but one can't fault the Chinese for lack of delivery. I always find my trips productive, and I greatly enjoy the exchange of economic and philosophical viewpoints with our counterparts. At times, my experiences in China are reminiscent of my Soviet past when life was not necessarily as comfortable as in the West but was nevertheless undoubtedly stimulating and character building.

Like pimple soup, the appearance and name might be somewhat off-putting, but the dish is nutritious and filling. As investors in China, we must be mindful that the recipes a country follows for achieving its economic and social objectives may draw on certain strengths and, indeed, represent potential pitfalls. However, they should not be confused with the goals themselves. Following this trip, it is fair to say that the menu of investment opportunities in China today requires close evaluation and a longer-term horizon but, with careful selection, investor appetites can still be satisfied.

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