Global Matters Weekly

12 August 2024

Delicate China

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The Chinese consumer, once a major driving force behind global luxury sales, is currently showing signs of weakness. This slowdown is influencing the broader economic landscape and the decline in consumer spending is having a huge impact on the luxury sector, leaving notable brands like Burberry and Kering (parent company of brands like Gucci, Balenciaga and YSL) particularly vulnerable.

The luxury market has long depended on Chinese consumers, whose appetite for high-end goods has fuelled significant growth. However, recent data indicates a cooling in this market. The economic slowdown in China, coupled with a decline in consumer confidence, has resulted in decreased demand for luxury products where brands such as Burberry and Kering have reported a significant slump in sales.

[1]Burberry, for instance, reported a 21% drop in quarterly sales in China, and the brand has now suspended its dividend and replaced its CEO, highlighting the severe impact of reduced Chinese spending. Its shares fell 16% on the day of the trading update and are now trading at levels not seen since 2010. Similarly, [2]Swiss watchmaker Swatch Group reported a substantial drop in sales in the first half of 2024, attributing the decline to weaker demand in China and forecasting a challenging market environment for the rest of the year. [3]Kering also saw its shares drop by 16% in July after reporting a decline of 12% in sales over Q2 2024, reflecting further concerns about sluggish Chinese consumer spending.

Several factors contribute to the current economic challenges in China. The country's GDP growth rate of 4.7% in the second quarter of the year fell short of expectations, despite government efforts to stimulate the economy. Falling property prices have also led to Chinese shoppers tightening their belts. This shift is particularly concerning for the luxury market, which relies heavily on middle-class spending. High youth unemployment further exacerbates the situation, leading to hesitation among consumers to invest in luxury goods amidst economic uncertainty.

Despite the current challenges, the long-term growth potential for the luxury market in China remains promising. The Chinese government continues to emphasise economic growth, setting a target of 5% for this year, which if met could help revive consumer spending. Official data from the People's Bank of China shows that household deposits reached a record of 146 trillion yuan as at the end of June, with Chinese households adding 9.3 trillion yuan to their savings in the first half of the year alone. However, this increase in savings is not yet translating into spending, dragging second-quarter growth down to 4.7%, below expectations of 5.1%. With sluggish retail sales increasing by just 2% in June, its slowest pace since December 2021.

Adding to the pressure, a weak yen has made luxury goods in Japan more attractive, driving wealthy Chinese consumers to shop abroad instead of at home. [4]LVMH for instance reported a 57% surge in sales in Japan over Q2 2024 (+44% over H1 2024), where many Chinese nationals are taking advantage of the favourable exchange rate. Similarly, Kering has seen sluggish demand in China but reported an increase in Japanese sales for the second quarter. Despite these shifts, China's high savings rate could support a swift recovery in luxury spending if consumer confidence rebounds.

Given the current weakness in Chinese consumer spending, this period could present a compelling opportunity to build or increase exposure to the luxury sector. Luxury markets are inherently cyclical and while we might not have reached the bottom yet, current conditions offer long-term investors a chance to build positions in strong brands at more attractive valuations.

The Chinese market remains a crucial area for luxury brands despite current economic challenges. Whilst the ongoing economic slowdown has clearly impacted consumer spending, brands that can successfully navigate this period by maintaining consumer engagement and adapting their strategies to align with current conditions will be well-positioned to benefit from a recovery. At Momentum, we have recently introduced Burberry to the portfolios within our direct UK equity exposure. We continue to see the company as having a valuable brand with a solid luxury core offering and assuming Burberry's brand equity remains intact, we believe the shares offer significant value. With much of the negativity already priced in, any upside in Chinese consumer spending could provide a substantial tailwind to the sector.

Sources: : [1]First Quarter Trading Update [2]Half-Year Report 2024 - Swatch Group [3]First-half 2024 results | Kering [4]2024-first-half-results-lvmh, slide 24 of Presentation.

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