MORNING BRIEFING
August 15, 2018

Trump vs Xi: Tiger vs Dragon?

See the collection of the individual charts linked below.

(1) China more vulnerable in trade war with US. (2) Xi aspires to Mao's power. (3) Xi's "new era" off to a bad start. (4) Deng nostalgia. (5) US targets Xi's "Made in China 2025." (6) Bad medicine. (7) Stress cracks in China's economy. (8) Chinese stocks coming under pressure. (9) Birth dearth. (10) Banking on more credit.

China I: Will Xi or Won't Xi? Blink, that is. No one really can hope to win a trade war, but in this game of tit-for-tat tariffs being played by the US and China, China is emerging as the more vulnerable.

The trade conflict has exacerbated an already slowing economy, a weakening currency, and a plunging stock market in China. It is eroding the notion of China's invincibility just five months after President Xi Jinping consolidated his hold on power by becoming leader for life and outlining a grandiose vision for China's global ambitions. That move followed Xi's elevation last October to a status on a par with the founder of the People's Republic of China, Mao Zedong, and the inclusion of Xi's "new era" political ideas and philosophy in the party constitution.

Xi has suffered numerous humiliations at the hands of Trump, most recently when Xi's top economic adviser, Liu He, declared there would be no trade war upon returning from negotiations in Washington in May. Trump immediately imposed $34 billion in tariffs on China, with $16 billion more in the works.

With President Trump ratcheting up the pressure and after missteps and miscalculations by China, China's new goal—as voiced at the summer meeting of the Politburo on July 31—is to maintain stability in the economy and the financial markets, noted an 8/12 *FT* piece.

Will Xi (the dragon) be forced to blink by Trump (the tiger)? I asked Sandra Ward, our contributing editor, to examine recent developments. Here's her report:

(1) *Tariffs, tariffs, and more tariffs.* The second round of Trump's tariffs is scheduled to take effect August 23 on $16 billion in Chinese exports. Beijing will match the move by slapping duties on an equivalent amount of US goods. This follows July's opening salvo when the two placed duties on $34 billion of each other's bilateral exports.

More recently, Trump threatened to tax an additional $200 billion of Chinese exports at 25%. That could lead to nearly half the $505 billion China exports to the US, about 19% of its total exports, being taxed at 25%, according to the *FT* article cited above. China has already taxed $110 billion in US exports of a total $130 billion (*Fig. 1*).

Should the additional tariffs go through, the impact would shave 1% from China's GDP, according to Gavekal Dragonomics, an 8/9 CNBC story noted.

(2) *Faster pace on economic reforms.* One possible outcome of US trade pressure: Beijing could pick up the pace on enacting economic reforms, noted the CNBC story. Among the reforms: allowing private investment into state-owned firms, transferring 10% of state-owned shares into pension funds, and reducing taxes for corporations and individuals.

China has made significant progress in moving to a consumer-led economy, and domestic consumption has become a more important driver of growth than investment and exports combined, according to a 6/5 analysis by Stratfor Worldview. Stratfor notes China's services industry—including finance, e-commerce, and logistics—is booming and represents about 45% of total employment compared with 23% a decade ago. Export-related employment has dropped from 9% of total employment in 2008 to an estimated 6% today. Still, China has little room to maneuver in the event of a more significant trade blow, as high debt levels and diminishing investment returns will limit its ability to stimulate the economy.

(3) *Daring to dissent.* The fallout from the escalating trade war has led to rare public displays of sniping in the ranks of the Communist Party, with a central bank official sharply criticizing the Ministry of Finance's fiscal policy for not being more stimulative, according to a 7/26 report in the *WSJ.* And a prominent academic wrote a widely circulated essay critical of the direction in which Xi is taking the country and called for reinstating term limits, a 7/31 *NYT* article reported.

(4) *Yearning for Deng.* Other academics are urging Xi to soften his rhetoric and adopt a leadership approach similar to that of Deng Xiaoping, paramount leader of China from 1978 through 1989. Deng was a reformer who modernized China by introducing free-enterprise principles to the economy and followed the maxim: 'Hide your strength, bide your time."

One example of that line of thinking was quoted in the *NYT* story: "China should adopt a lower profile in dealing with international issues," Jia Qingguo, a professor of international relations at Peking University, said at a recent forum in Beijing. "Don't create this atmosphere that we're about to supplant the American model."

An 8/7 *Bloomberg Businessweek* piece also discussed the reappraisal of Xi that's occurring in China as a result of the trade war, noting a "newfound sense of self-doubt." It quoted Wang Yiwei, a professor of international affairs at Renmin University in Beijing and deputy director of the school's Xi Jinping Thought Center, saying "The trade war has made China more humble. We should keep a low-profile." He noted, too, that this might mean rethinking Xi's audacious One Belt, One Road infrastructure project, modeled on the ancient Silk Road, that would link China with trading partners throughout Asia and Europe.

(5) *Made in China 2025.* Officials appear to be heeding some of the criticism. State media outlets were told to downplay "Made in China 2025," China's bold industrial initiative to become a dominant force in 10 advanced and strategically important sectors, including robotics, semiconductors, and aerospace, according to a 6/26 Politico story. The US has identified Made in China 2025 as a major threat, and is seeking to block Chinese-owned companies from buying tech-rich US companies.

(6) *Summer of discontent.* Exacerbating what the *Businessweek* article dubbed Xi's "summer of discontent" is a public health scandal that erupted in July. A vaccine maker was found to have faked reports and skirted regulations, producing ineffective vaccinations for rabies, diphtheria, pertussis, and tetanus that were administered to 250,000 children. The public outcry has been enormous and proven difficult to control by censors, according to a 7/24 piece by *The Guardian.* It has also led to a sell-off in Chinese drug stocks.

China II: Stress Fractures. China's economy has been slowed by the escalating trade war with the US. Here's a rundown of some of the evidence:

(1) *Currency weakness.* The yuan is Asia's worst performing currency over the past three months, down 8% against the dollar. To blame, according to an 8/13 Bloomberg report, are trade tensions and the People's Bank of China's (PBOC) moves to support the economy by devaluing the currency, making Chinese goods more affordable (*Fig. 2*). On the other hand, China's central bank recently made it more expensive to short the yuan, which served to stabilize it.

(2) *Manufacturing trends.* China's official M-PMI fell for the second straight month in July, to 51.2, after climbing from 50.3 in February to an eight-month high of 51.9 in May. Both the output (to 53.0 from 54.1) and new orders (52.3 from 53.8) measures showed growth eased over the two-month period, while new exports orders (49.8) contracted slightly for the second month, at the same pace as June. Meanwhile, factory employment continues to decline, though at a slower pace, edging up from 49.0 to 49.2 last month; it has averaged 49.1 the past five months (*Fig. 3*).

(3) *Bank reserve requirements.* The PBOC cut the amount of cash banks must hold in reserve for the third time this year to encourage debt-for-equity swaps, which ease debt burdens, and to boost lending to small firms (*Fig. 4*).

(4) *Dr. Copper.* Copper prices fell to a 13-month low Tuesday, down 19% from four-year highs in June, as investors worry about the trade war's impact on demand from China, which represents about half of global copper demand (*Fig. 5*).

On the other hand, China's producer price index jumped 4.6% y/y in July, and the consumer price index rose 2.1%—both strong showings in light of the trade wars (*Fig. 6*).

(5) *China stock markets.* The Shanghai Stock Exchange Composite Index and the Shanghai Shenzhen 300 both are down more than 16% ytd, and down 22% from their 52-week intraday highs, bringing the indexes into bear-market territory (*Fig. 7*).

China III: Ticking Time Bombs. Some threats to China's long-term growth prospects have no easy fixes. China's longtime one-child policy has birthed a demographic time bomb—i.e., an aging population and shrinking workforce that will hinder economic growth. And China is one of the countries most at risk for a banking crisis, according to the Bank of International Settlements, because of its massive debt load. Let's look more closely at these areas:

(1) *Baby bust.* After 35 years of strictly enforcing a one-child-per-family policy to address an overpopulation problem, China now faces the opposite problem: not enough workers to support an aging population (*Fig. 8*). Despite easing the restrictive policy in 2016 and encouraging women to have two children, many are sticking with one or none. And there are fewer women to bear children as a result of the one-child policy. The government is now trying frantically to create a baby boom, an 8/11 *NYT* article reports, by providing incentives such as tax breaks and housing and education subsidies and by limiting abortions and divorces.

(2) *Bank bust?* Chinese banks issued 1.45 trillion yuan ($211 billion) in net new loans in July, as the government increased its support for banks and encouraged lending to small businesses and infrastructure projects, according to an 8/13 report on Reuters. Outstanding yuan loans grew a larger-than-expected 13.2% y/y (vs a 12.8% consensus estimate)—faster than June's 12.7%.

While monetary policy has been stimulative, fiscal policymakers may be stepping on the brakes. Fixed-asset spending on items such as factory machinery and public works projects fell to the lowest level since 1999, an 8/14 *WSJ* article pointed out. Fixed-asset investment in nonrural areas grew at a 5.5% y/y pace in the seven-month period from January to July compared to 8.3% growth in the year-earlier period. Shuang Ding, an economist with Standard Chartered Bank in Hong Kong, told the *WSJ* this was evidence that "China can't go toe-to-toe in retaliating" against the US.

China is faced with the delicate balancing act of trying to reduce its massive debt load—estimated at about 270% of GDP—while staving off a sharp slowdown from the effects of the trade war.

Will Xi blink?

CALENDARS

US. Wed: Retail Sales Total, Ex Auto, Ex Auto & Gas, and Control Group 0.1%0.4%/0.4%/0,4%, Business Inventories 0.1%, Headline & Manufacturing Industrial Production 0.3%/0.3%, Capacity Utilization 78.2%, Empire State Manufacturing Index 20.0, Productivity & Unit Labor Costs (saar) 2.5%/-0.2%, Housing Market Index 69, Atlanta Fed Business Inflation, Treasury International Capital. **Thurs:** Housing Starts & Building Permits 1.271mu/1.307mu, Jobless Claims 215k, Philadelphia Fed Manufacturing Index 22.5, EIA Natural Gas Report. (*Wall Street Journal* estimates)

Global. Wed: UK Headline & Core CPI 2.5%/1.9% y/y. **Thurs:** Eurozone Trade Balance €15.5b, UK Retail Sales Including & Excluding Auto Fuel 2.9%/2.7% y/y, Australia Employment Change & Unemployment Rate 15k/5.4%, RBA Governor Semiannual Testimony. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q2 Earnings Season Monitor (*link*): With Q2 earnings beginning to stream in for the retailers, results are now in hand for 91% of the S&P 500 companies. We're finding a higher percentage of companies reporting positive surprises than at the same point during the Q1 earnings season but a lower overall percentage surprise. Year-over-year growth rate metrics for the Q2 reporters to date are close to Q1's historically high levels. More specifically, of the 455 companies in the S&P 500 that have reported through mid-day Tuesday, 80% exceeded industry analysts' earnings estimates by an average of 5.2%; they have averaged a y/y earnings gain of 26.5%. At the same point during the Q1-2018 reporting period, a lower percentage of companies (79%) in the S&P 500 had beaten consensus earnings estimates by a higher 7.3%, and earnings were up a lower 24.9% y/y. On the revenue side, 72% of companies beat their Q2 sales estimates so far, with results coming in 1.6% above forecast and 10.1% higher than a year earlier. At this point in the Q1 season, a higher 76% of reporting companies had exceeded revenue forecasts by a lower 1.1%, and sales had risen by a lower 8.4% y/y. Q2 earnings results are higher y/y for 84% of companies, vs a higher 86% at the same point in Q1, and Q2 revenues are higher y/y for 86% vs a higher 87% a quarter ago. These results are very encouraging, particularly the percentage of companies growing revenues y/y and their Q2 surprise. Q2-2018 marks the eighth straight quarter of positive y/y earnings growth and among the highest growth since Q4-2010. The strong results are mostly due to lower tax rates and improved business conditions.

MSCI Europe ex-UK Q2 Earnings Season Monitor (*link*): With the Q2 season nearly complete for the MSCI Europe ex-UK index, we find a similar percentage of companies reporting positive earnings surprises than during the Q1 season, but a lower overall percentage surprise. Looking at the results for revenues, a higher percentage of companies has reported a positive revenue surprise in Q2 than Q1, but aggregate revenues have missed forecasts by 1.7%, the biggest percentage miss since we started analyzing the data in Q1-2011. Of the 197 companies in the MSCI Europe ex-UK that have reported quarterly earnings results through mid-day Tuesday, 53% exceeded industry analysts' earnings estimates by an average of 4.0%; they have averaged a y/y earnings gain of 7.9%. During the Q1-2018 reporting period, a similar percentage of companies (53%) had beaten consensus earnings estimates by a higher 4.5%, and earnings were up a lower 5.7% y/y. On the revenue side, 62% of companies beat their Q2 sales estimates so far, with results coming in 1.7% below forecast (as mentioned above) and 2.1% higher than a year earlier. During the Q1 season, a lower 47% of reporting companies had exceeded revenue forecasts, but aggregate revenues missed forecasts by a smaller 1.0%, and sales had risen by a lower 0.1% y/y. Q2 earnings results are higher y/y for 64% of companies, vs a lower 61% in Q1, and Q2 revenues are higher y/y for 70% vs a higher 58% a quarter ago.

US ECONOMIC INDICATORS

NFIB Small Business Optimism Index (*link*): "Small business owners are leading this economy and expressing optimism rivaling the highest levels in history," said NFIB President and CEO Juanita Duggan. "Expansion continues to be a priority for small businesses who show no signs of slowing as they anticipate more sales and better business conditions." July's Small Business Optimism Index (SBOI) rose from 107.2 to 107.9 last month, marking its second-highest level in the survey's 45-year history—climbing to within a tenth of a point of July 1983's record high of 108.0. Of the 10 components of the SBOI, six increased, while current inventory (to -3% from 0%) and plans to increase inventories (4 from 6) declined and earnings trends (-1) and expected credit conditions (-4) were unchanged. The headline from the components contributing positively was that job creation (23 from 20) and job openings (37 from 36) set records last month. Meanwhile, July was the eighth straight strong month of expected sales gains (29 from 26), while owners expecting better business conditions (35 from 33) continued to fluctuate around very elevated levels. Also contributing positively to July's SBOI: now is a goods time to expand (32 from 29) and capital outlay plans (30 from 29)—with the former just 2ppts below May's record high of 34%. Easily holding onto the top spot as "single most important business problem" was finding qualified workers, while concern about taxes, government regulation, and poor sales remained on steep downtrends.

Import Prices (*link*): Import prices during the two months ending July were basically flat after big gains the previous two months. Total import prices were unchanged in July after ticking down a revised -0.1% (from -0.4%) in June; prices had jumped 1.3% during the two months through May. Petroleum prices rose for the fourth month, up 0.9% m/m and 15.1% over the period. Meanwhile, nonpetroleum import inflation remains subdued, falling -0.4% in the two months through July, after increasing a total of only 0.2% the prior three months. The yearly rate for import prices in July was 4.8% y/y—the highest since February 2012—as petroleum products (43.6% y/y) rose at the fastest pace in 16 months and nonpetroleum (1.3) matched June's pace, which was the slowest in six months. The rate for capital goods imports (0.3) eased for the third month after a steady acceleration from -2.5% at the end of 2015 to 1.1% during March and April of this year, while the rate for industrial materials & supplies (20.9) was at a 16-month high. Meanwhile, rates for both consumer goods ex autos (0.6) and autos (0.3) remained in volatile flat trends around zero, with the former at the top of its range; the rate for food prices (-3.8) turned negative in June for the first time in two years, and continued to slide in July.

GLOBAL ECONOMIC INDICATORS

Eurozone GDP Flash Estimate (*link*): The Eurozone economy expanded 0.4% during Q2, according to the GDP flash estimate, matching Q1's pace but slowing from gains of 0.7% during the last half of 2017. Among the four largest Eurozone economies, Spain (0.6%) and Germany (0.5) were above the Eurozone's 0.4% real GDP growth rate last quarter, while France (0.2) and Italy (0.2) fell short. The Eurozone grew 2.2% y/y, slowing from 2.5% during Q1 and 2.8% at the end of last year. Among the four, only Spain (2.7% y/y) exceeded the Eurozone's 2.2% rate; Germany (1.9), France (1.7), and Italy (1.1) were below.

Eurozone Industrial Production (*link*): Output contracted in June for the fifth time since reaching a cyclical high in November. Industrial production (excluding construction) sank -0.7% in June, on widespread weakness, after jumping an upwardly revised 1.4% (from 1.3%) in May; production is down -1.2% since November's cyclical high. Here's a look at how output in the main industrial groupings performed in June and since November's cyclical high: Production of capital goods (-2.9% m/m, -5.0% since November) was down the most since November, while consumer nondurable goods (-0.6, 2.0) was up the most—coming in just below May's record high. Output of both intermediate (-0.5, -0.4) and consumer durable (-0.5, -0.9) goods were only slightly negative since November, while energy (0.5, -3.2) increased in June but was down sharply the past seven months. Data available for the top four Eurozone economies show output rose in France (0.6) and Italy (0.5) during June, and fell in Spain (-0.7) and Germany (-0.6). Among the Eurozone countries for which data are available, the largest decreases in industrial production in June were registered in Ireland (-8.9) and the Netherlands (-1.3); the largest increases were posted by Finland (1.5) and Portugal (1.1).

Contact us by email or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-775-6823