



MORNING BRIEFING

August 14, 2019

China, China, China

See the [collection](#) of the individual charts linked below.

(1) Growing old before growing rich. (2) Dazzling infrastructure. (3) Ghost trains and ghost airports? (4) Bordering on PPI deflation again. (5) M1 growth weak, while M2 growth heading lower. (6) Less bang per yuan. (7) Trump's Christmas present. (8) Hong Kong is a no-win for Beijing. (9) Meet Xi Jinping. (10) Meet Hu Xijin.

China I: Speeding Toward Slower Growth. In recent years, China watchers have been debating the following question: Will China grow old before it grows rich? The current snapshot of China compared to snapshots taken 10, 20, and 30 years ago shows that it has gotten much richer. Standards of living have certainly improved for most people in China. China's infrastructural achievements—the highways, railways, ports, and cities—all are dazzling.

On the other hand, the following negative spin appeared in a 5/23/17 [opinion piece](#) in the *South China Morning Post*: “The underlying reality is of a fundamentally indebted, extremely unequal and vastly over-built society that is going to be knocked sideways by its own demographic earthquake—as decades of the one child policy come home to roost—and China's population growth starts to falter.”

One salient example of the yin-and-yang dynamics of China's economy is the country's high-speed rail system, the longest in the world. It's extremely impressive, with 29,000 kilometers (18,000 miles) of rail operating as of year-end 2018. One critic, however, Zhao Jian—director of the China Urbanization Research Center at Beijing Jiaotong University—says the rail network is fraught with problems, which he reviewed in a 1/29 Caixian [article](#) titled “What's Not Great About China's High-Speed Rail? The Debt.”

The problems Zhao sees include the system's high cost, inefficiency as measured by “transportation density,” massive debt financing (with total liabilities of 5.28 trillion yuan as of September), and the fact that investing in this system, which carries only people, has meant less construction of regular railways, which has led to a serious imbalance in China's transportation infrastructure.

My take is that China runs the risk of having lots of state-of-the-art “ghost” infrastructure. We've all seen YouTube videos of China's [ghost cities](#). They are a bit of an urban legend in which the government built vast, sprawling, futuristic metropolises in the middle of nowhere that nobody actually lives in. While most have failed to live up to their original promise, few have failed completely. Their populations are growing.

Nevertheless, China's rapidly aging demographic profile does increase the risk that China has built too much ghost infrastructure that will be plagued by excess capacity and burdensome debt.

China II: Managing Slower Growth. The Chinese government has provided lots of fiscal and monetary stimulus to manage the slowdown in China's economy. It is slowing partly because that's what emerging economies do as they mature into developed economies. But the slowdown has been greatly exacerbated by the one-child policy from 1980 to 2015. China's fiscal policy has focused on building infrastructure, which has been creating excess capacity, as discussed above. Monetary policy has enabled too much debt expansion, which is weighing on China's economy rather than stimulating it. Let's review the recently released data on China's economy:

(1) *Inflation.* China's CPI rose 2.8% y/y during July, boosted by food prices—particularly pork prices, which have soared as a result of the swine flu epidemic ([Fig. 1](#)). Higher food prices reduce the purchasing power of Chinese consumers. The PPI fell 0.3% y/y in July, which suggests that China's manufacturing sector is weakening, with industrial profits under pressure. That is likely to put financial stress on many of China's manufacturers, who already face challenges from Trump's escalating trade war.

(2) *Money supply.* M2 rose 8.1% y/y during July ([Fig. 2](#)). This growth rate has declined from 14.0% at the beginning of 2016. This may be yet another indicator of China's economic slowdown. Since early 2016, it has diverged from the growth rate in bank loans, which has been relatively steady around 13.0%. In the past, M2 growth tracked bank loans growth closely. The recent divergence confirms our view that easy credit policy isn't stimulating the economy as much as it might have in the past.

M1 growth remains low around 3.1% ([Fig. 3](#)). It tended to grow much faster during periods of monetary stimulus. It's not doing so even though the People's Bank of China (PBOC) lowered the reserve requirement ratio for large banks from 17.0% at the start of 2017 to 13.5% currently ([Fig. 4](#)).

(3) *Real retail sales.* The growth rate in inflation-adjusted M2 is highly correlated with the growth rate in inflation-adjusted retail sales ([Fig. 5](#)). Both have been on downward trends since 2013. Again, in our opinion, these downtrends reflect the increasingly geriatric demographic profile of China.

(4) *Bank loans.* The cuts in the reserve requirements ratio by the PBOC have kept bank loans growing at a fast pace, as noted above. The PBOC has been filling up the punch bowl regularly ever since the Great Financial Crisis. As a result, bank loans have soared by \$17.0 trillion from \$4.4 trillion at the start of 2009 to \$21.4 trillion during July of this year ([Fig. 6](#)). Over the same period, US bank loans rose only \$2.9 trillion to \$9.8 trillion.

Over the past 12 months through July, Chinese bank loans rose \$2.4 trillion ([Fig. 7](#)). Total "social financing," which includes bank loans, rose \$3.3 trillion over the same period ([Fig. 8](#)).

All that lending seems to be delivering less and less bang per yuan. The ratio of M2 to bank loans (both in yuan) was relatively flat from 2006 to 2014, but has been falling ever since ([Fig. 9](#)). The ratio of industrial production to bank loans has been on a steep downtrend from record high of 107 during December 2007 to 52 during June of this year ([Fig. 10](#)).

China III: Hong Kong Coming to a Boil. Stocks rebounded yesterday after the Trump administration de-escalated its trade war with China. Tariffs will be delayed until 12/15 on imports from China of cellphones, laptop computers, toys, and other items. No reason was given, but US importers must have put lots of pressure on the administration to back off. Or perhaps President Trump doesn't want to force American consumers to pay more for many of their made-in-China Christmas presents this year before the November presidential election next year.

Now what if China uses lethal force to end the pro-democracy protests in Hong Kong? Obviously, the US can't respond militarily to any carnage that might ensue. The only viable option might be to reverse course again and impose a tariff on the remaining \$300 billion of Chinese goods imported into the US. Instead of the 10% tariff that was just delayed, a much more punishing rate might be necessary in response to an attack by Chinese military forces on Hong Kong's civilians.

One of the biggest differences between current events in Hong Kong and the massacre at Tiananmen Square during June of 1989 is the proliferation of smartphones and social media. That could cause the Chinese government either to back off or to create a global firestorm for the regime if it proceeds with a bloody crackdown. The question is: What will President Xi Jinping do?

China IV: Meet Xi Jinping. Communism is in Chinese President Xi Jinping's blood. His father, Xi Zhongxun, was an original communist revolutionary who worked his way up to become vice premier of the PBOC in the first generation of Chinese communist party leadership. Like his father, Xi Jinping spent several decades climbing political ranks in various roles serving the agenda of the Chinese communist party. Though a communist at heart, Xi, the son, projects a more liberalized persona as a voice of globalization and international cooperation. But don't doubt his commitment to communist ideals: Xi initially applied to join the Chinese Communist Party nine times before being accepted on the tenth during 1974. Let's further explore Xi's dual personality:

(1) *Supreme leader vs president.* Many US news journalists, politicians, and analysts (including ourselves) often refer to Xi Jinping as "President Xi." Technically, this is wrong, but China sees symbolic advantage internationally in not correcting it, according to an [8/8 Slate article](#).

The article points out that calling Xi "president" makes it sound like China goes through some of the motions of democracy. Hardly: During his reign, Xi successfully has abolished term limits, granting him leadership over China for an unlimited amount of time.

Xi actually has three titles: "General Secretary of the Central Committee of the Chinese

Communist Party,” a.k.a. “General Secretary,” most used for domestic purposes; “Chairman of the Central Military Commission;” and “Head of the People’s Republic of China,” the one often mistranslated as “president.” This misnomer helps to support Xi’s diplomacy on a global basis, surmises Slate. Xi also holds a seat on China’s top policy-making body, the Politburo Standing Committee. Internally, General Secretary Xi runs a tightly controlled state. Internationally, President Xi promotes globalization and free trade.

But make no mistake: Xi is anything but a democratic leader. China is fully a one-party system that forcibly squelches any opposition. Since taking on the role of General Secretary in 2012, Xi has led a signature internal anticorruption campaign, cracking down hard on dissenters and, of course, political opponents, even wiping out some long-standing members of the Politburo. Xi has usurped centralized control over the nation, taking on a variety of party leadership positions. His political philosophies, termed “Xi Jinping Thought,” has been made a permanent part of the Communist Party constitution.

(2) *Global liberalizer vs domestic controller.* It was in December of 1978 that Xi’s predecessor, Deng Xiaoping, brought China out of Maoist communism into “socialism with Chinese characteristics.” When Xi came to power, it was hoped that he would walk in Deng’s footsteps, further democratizing markets. But in reality—as Xi has faced slowing domestic growth, the US trade dispute, human-rights violations, loads of debt, and lagging consumption—the state sector has grown while the private sector has shrunk as credit conditions have tightened, observed an [article](#) in *The Guardian* covering China’s 40th anniversary of its initial economic transition.

Xi gave a speech that day capturing the essence of his duality—both painting China as a paragon of global cooperation and asserting that no one tells the party how to control China. On one hand, he said: “China will never seek global hegemony. ... China is approaching the center of the World Stage and has become a recognized builder of world peace, a contributor to global development, and a defender of the international order.” On the other hand, he said: “No one is in a position to dictate to the Chinese people what should or should not be done. ... Whether it’s the party, the government, the army, ordinary people, or students, the east, the west, the south, the north or the middle, the party leads everything.”

Chinese leadership has always been “absolutely correct,” he noted, pointing out China’s accomplishments over the past decades in abolishing hunger and hardship that “plagued our people for thousands of years.”

(3) *Opposing initiatives.* At the World Economic Forum in Davos in January, Xi said that “protectionism is like locking oneself in a dark room. Wind and rain may be kept outside, but so are light and air,” according to an 8/12 [article](#) in *Worth* magazine on Xi’s rise to power. As an active participant in globalization, Xi has promoted foreign infrastructure projects and collaborated on global trade deals.

Worth observed: “Within months of President Trump’s withdrawal from the Trans-Pacific Partnership trade deal, China initiated trade talks with the other member nations as well as South Korea. Similarly, when Trump withdrew the U.S. from the Paris Agreement, Xi raised a

potent call for global cooperation on climate change, warning about a risk to the global economy.” Separately, China’s Belt and Road project aims to build infrastructure by land and sea to connect Asia, Europe, the Middle East, and Africa.

However, these seemingly innocuous activities seem to be priming for the exact positioning that Xi has promised not to pursue—global dominance, particularly over and above the US. Counter to the idea of China’s friendly global involvement, Xi’s deputy, Chinese Premier Li Keqiang, issued the “Made in China 2025” strategic plan to dominate the high-tech industry. The US has identified this strategy as a major threat to US intellectual property as China seeks to steal US technologies, an injustice that sits at the core of the US-China trade dispute.

Amid Xi’s friendlier global initiatives, China has been quietly expanding its military capacity in the disputed islands of the South China Sea. The country has also been policy-meddling in the semi-autonomous region of Hong Kong, sparking the recent unprecedented riots there. Moreover, the country’ has long come under international criticism for its human rights violations, including atrocities related to its only recently abolished one-child policy and, recently, the detainment of a large population of Chinese Muslims.

The bottom line is that the undercurrent of China’s actions beneath Xi’s promises make it hard to trust that his motives are pure and that he is not seeking global hegemony as he claims. The next litmus test for Xi may be how he chooses to handle the situation in Hong Kong. If he reacts with force, it would be a major line in the sand, revealing his true nature as an authoritarian communist.

China V: Meet Hu Xijin. On a 2016 visit to the *People’s Daily*—a primary domestic news source controlled by the Chinese communist party—Xi said that his office subscribes to the *Global Times*, according to an [article](#) in the Lowy Institute’s *The Interpreter*. The tabloid-like *Global Times* is a subsidiary of the *People’s Daily*, and its editorials are often characterized as outlandish and lacking in substance. But the media outlet sometimes dubbed “China’s Fox News” echoes the views of the communist party and its loyal supporters.

One of those loyalists is the *Global Times*’ own deputy editor, Hu Xijin. In a 7/31 [article](#), the *NYT* said that Hu is sometimes called a “frisbee fetcher” by critics, i.e., a party loyalist who retrieves whatever is thrown at him by the party. The article reports that Hu acknowledges that he has “special access” to party officials. Strangely, Hu was one of the student marchers for democracy at Tiananmen Square but left just before the horrific attacks on protestors.

Hu claims to have been deceived back then by pro-democracy intellectuals who were impulsive and childish, according to the *NYT*. Hu has not been shy about [tweeting](#) messages calling for today’s protestors in Hong Kong to stand down. Hu also has publicly [supported](#) the Muslim “reeducation” camps in Xinjiang.

There is no shortage of entertainment on social media, but it is not all fun and games. Often, the Chinese media maven stays up late into the night in Beijing, standing at the ready to [tweet](#) back at anything President Trump comes online to say. The editor views the west as

“demonizing” China and has said that military conflict with the US cannot be ruled out, reported the *NYT*.

CALENDARS

US. Wed: Import Prices -0.1%*m/m*/-2.0%*y/y*, MBA Mortgage Applications, DOE Crude Oil Inventories. **Thurs:** Retail Sales Total, Ex Autos, Ex Autos & Gas, and Control Group 0.3%/0.4%/0.5%/0.4%, Industrial Production Headline & Manufacturing 0.1%/-0.3%, Capacity Utilization 77.8%, Business Inventories 0.1%, Nonfarm Productivity & Unit Labor Costs 1.4%/1.8%, Jobless Claims 212k, NAHB Housing Market Index 66, Empire State Manufacturing Index 1.9, Philly Fed Manufacturing Index 10, Treasury International Capital, EIA Natural Gas Report. (DailyFX estimates)

Global. Wed: Eurozone GDP 0.2%*q/q*/1.1%*y/y*, Eurozone Industrial Production -1.4%*m/m*/-1.5%*y/y*, Germany GDP -0.1%*q/q*/0.1%*(wda)y/y*, UK Headline & Core CPI 1.9%/1.8% *y/y*, China Retail Sales 8.6% *y/y*, China Industrial Production 6.0% *y/y*, China Fixed Assets Ex Rural (ytd) 5.9% *y/y*. **Thurs:** UK Retail Sales Ex Auto Fuel 2.3% *y/y*, Japan Industrial Production, Australia Employment Change & Unemployment Rate 14k/5.2%. (DailyFX estimates)

STRATEGY INDICATORS

S&P/Russell LargeCaps & SMidCaps (*link*): All of these price indexes have healthy gains so far in 2019, but are in minor correction now from their 2019 highs. The LargeCaps indexes had been back at record highs in late July, but the SMidCaps remained mostly in a correction from their record highs of August 2018. Here’s how they rank ytd through Monday’s close, along with their percentage changes since their record highs: Russell LargeCap 1000 (15.3% ytd, -4.3% from record high), S&P LargeCap 500 (15.0, -4.7), S&P MidCap 400 (12.6, -8.7), Russell SmallCap 2000 (10.8, -14.1), and S&P SmallCap 600 (9.0, -16.2). Forward earnings dropped simultaneously for all three indexes for the first time since mid-April but remain in the uptrends that began during March. LargeCap’s has risen during 21 of the past 26 weeks, MidCap’s 14 of the past 22 weeks, and SmallCap’s 11 of the past 20 weeks. LargeCap’s is down 0.1% from its record high a week earlier, while MidCap’s and SmallCap’s weakened to 1.6% and 6.3% below their mid-October highs. Analysts had been expecting double-digit percentage earnings growth for 2019 last October, but those forecasts are down substantially since then. Here are the latest consensus earnings growth rates for 2018, 2019, and 2020: S&P 500 LargeCap (22.7%, 1.8%, 11.4%), S&P 400 MidCap (22.7, -0.9, 13.5), and S&P 600 SmallCap (22.4, 0.3, 17.7).

S&P 500 Growth vs Value (*link*): The S&P 500 Growth and Value price indexes are down modestly from their recent highs, and remain strong ytd. The Growth index leads with a gain of 17.6% ytd through Monday’s close, but is down 4.3% from its record high on 7/26. Value is up 12.1% ytd, but is down 5.2% from its 2019 high on 7/26 and 6.3% below its record high more than 18 months ago on 1/26/18. Since the election in late 2016, Growth’s 48.1% gain is more than double the 20.4% increase logged by Value. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) and earnings growth (STEG) than Value over the next 12 months. Specifically, 8.4% STRG and 10.5% STEG are projected

for Growth, respectively, versus 3.9% and 6.4% for Value. Growth's valuation peaked at 21.8 on 7/26, matching January 2018's highest level since the Tech bubble deflated in 2002. Through Monday, Growth's P/E was down to 20.6, up from its 50-month low of 15.9 on 12/24. Value's forward P/E is down to 13.3 now from its 2019 high of 14.1 on 7/26. That's up from a six-year low of 11.5 on 1/3 of this year, but down from a 16-year high of 16.6 on 1/3/2018. Regarding NERI, Growth's was positive in July for a third month, but dropped to 0.2% from 2.9% in June. That compares to a 25-month low of -4.4% in February and a record high of 22.3% in March 2018. Value's NERI was negative in July for a ninth month, falling to -4.4% from -1.8%; that compares to a 34-month low of -9.8% in February and a record high of 21.2% in March 2018. The Tax Cuts and Jobs Act (TCJA) sharply boosted the consensus forward earnings estimates and the forward profit margin for both Growth and Value. They're rising again now after dropping in late 2018 but remain below their record highs. Growth's forward profit margin of 15.9% is up from 14.4% prior to the TCJA's passage, but down from its record high of 16.7% during mid-September. Value's forward profit margin of 10.2% is down from a record high of 10.5% in December, but up from 9.1% prior to the TCJA.

US ECONOMIC INDICATORS

CPI ([link](#)): July's core CPI rate accelerated slightly for the second month to 2.2% (above the Fed's 2.0% target rate) from 2.0% in May. It has fluctuated in a narrow band between 2.0% and 2.2% the past 12 months; it peaked at 2.4% last July, which was the fastest pace since September 2008. Here's a ranking of the core goods rates in July, lowest to highest: apparel (-0.5% y/y), medical care commodities (-0.4), new vehicles (0.3), used cars & trucks (1.5), alcoholic beverages (1.9), tobacco & smoking products (5.4); only the last one surpassed the total core rate of 2.2%. Here's the same drill for the core services rates: motor vehicle insurance (0.6), physicians' services (0.7), hospital services (0.8), airfares (1.3), motor vehicle maintenance & repair (3.3), owners' equivalent rent (3.4), and rent of primary residence (3.8). The rate for auto maintenance & repair was on a steep accelerating trend, though is now heading lower, while rent of primary residence remains on a slight accelerating trend. Meanwhile, costs for hospital services and motor vehicle insurance remain on sharp decelerating trends. Core prices rose 0.3% for the second month in July—the biggest monthly gain since January 2018—after gains of 0.1% in each of the prior four months. These back-to-back gains pushed the three-month core rate up to a 17-month high of 2.8% (saar) from 1.6% in May and April—which was the slowest July 2017. The headline CPI rate ticked up to 1.8% y/y after easing from 2.0% in April to 1.6% in June. It was at a recent high of 2.9% last July.

NFIB Small Business Optimism Index ([link](#)): “Contrary to the narrative about impending economic doom, the small business sector remains exceptional. This month's index is a confirmation that small business owners remain very optimistic about the economy but are being hamstrung by not finding the workers they need,” noted William Dunkelberg, NFIB's chief economist. According to the report, 26% reported finding qualified workers as their number one problem—a record percentage in the 45-year history of the survey. The Small Business Optimism Index (SBOI) recovered to 104.7 in July (within 4.1 points of last August's record high of 108.8) after falling in June (to 103.3 from 105.0) for the first time this year; it was at 101.2 in January—which was the lowest reading since November 2016. In July, seven of the 10 components rose, while the current inventory (to -3% from 0%) and expected credit

conditions (-4 from -3) components fell and plans to increase inventories was unchanged at 3%. The biggest positive contributors to the SBOI last month were sales expectations (to 22% from 17%), business conditions (20 from 16), hiring plans (21 from 19), current job openings (39 from 36), and earnings trends (-4 from -7). Meanwhile, the Uncertainty Index sank to an 11-month low of 76 in July after jumping to a 28-month high of 87 in June.

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