



MORNING BRIEFING

September 18, 2019

China's Hurting

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

(1) Managing China's declining growth rate. (2) A lot of homegrown structural problems. (3) Trade war with US is weighing on China's economy too. (4) Showing signs of wanting to make a deal with US. (5) Lots of hard data. (6) Growth of industrial production and real retail sales both fall below 5.0%. (7) Excerpts of woeful tales. (8) Another important Fed meeting. Aren't they all?

China I: Needing a Trade Deal. China's economy is faltering, as the latest data continue to show. Numerous attempts by Chinese government and central bank officials to stimulate the economy are simply slowing the inexorable downward trend in economic growth.

Melissa and I have previously analyzed the strong secular forces driving the downtrend, including the country's aging population and its increasingly burdensome public and household debt load. They may prove to be too powerful to overcome. Officials already have attempted—and dialed back attempts—to deleverage, have buried their one-child limits, and have unleashed massive amounts of fiscal and monetary stimulus to little avail. China's economic growth has slowed to a relatively lackluster pace and continues to head lower.

The US-China trade dispute is only worsening China's homegrown economic challenges. Perhaps that's why Chinese officials recently seem more open to making a trade deal with the US sooner rather than later. After weeks of heightened tensions and an apparent hold on talks, China's Ministry of Commerce [announced](#) on 9/5 that the two countries agreed to conduct high-level trade talks in Washington, DC early next month.

To prepare for these talks, both countries will begin consultations this week. Following that, US Trade Representative Robert Lighthizer and US Treasury Secretary Steven Mnuchin are expected to meet with China's top negotiator, Vice Premier Liu He, [reported](#) Reuters. By sending Liu He to the US table, it signals that China may be serious about deal-making. Another such signal came on 9/11, when China's Tariff Commission of the State Council announced that it will exempt certain types of US imports from additional tariffs, effective for a year from 9/17.

Providing the US with plenty of negotiating leverage, China's recent economic data have taken a hit on several fronts as a result of its domestic and geopolitical problems. There may be more woes to come, as more multinational companies are moving previously planned investments away from China, [according](#) to CNBC.

Perhaps complicating Chinese officials' readiness to deal, however, is the fact that the US in trade talks has raised issues that threaten China's ascendance as a superpower. Their stated plan to realize global dominance hinges on practices that the US won't tolerate. For China, the trade talks aren't about "trade or the economy, stupid," but rather the politics of nationalism and global power. One need not

look much further than China's [militarism](#) in the South China Sea for evidence of this dynamic.

For the US, we know for sure that the negotiations are not just about trade but also about unfair business practices and national security concerns, as we have discussed on numerous previous occasions. Important components of this are international property theft and forced technology transfer. Before the talks broke down in early May, China apparently acknowledged these concerns for the first time, after having previously denied and dismissed them, [reported](#) Reuters.

China II: Hard Data. In any event, here is a roundup of some of China's latest disappointing data:

(1) *Industrial production & real GDP.* China's industrial production growth peaked at more than 20.0% y/y during 2010, then fell into the teens during 2011. It continued a steep decline to about 6.0% in 2015, about where it stayed until early 2018, right before the US-China trade dispute started and escalated. The series rebounded to about 9.0% early this year, likely due to some front-loading ahead of anticipated tariffs, or perhaps just a statistical anomaly. In any case, it has since dipped to only 4.4% y/y during August, the slowest growth seen since the Great Recession. China's real GDP growth fell to 6.2% y/y in Q2, down from 6.7% a year ago ([Fig. 1](#)).

(2) *Industrial profits.* In the first two months of this year, Chinese industrial firms' profits fell 14.0% y/y, [according](#) to an 8/22 *South China Post* (SCMP) article citing the latest data from the National Bureau of Statistics. That was the sharpest contraction since 2009. Manufacturing profits fell by 15.7% y/y, with profits from oil-processing companies dropping 70.4%.

(3) *Manufacturing Purchasing Manager's Index (M-PMI).* China's official M-PMI dropped to a seasonally adjusted 49.5 during August. Two out of the three components of the composite index fell further below 50.0. Employment and new orders fell to 46.9 and 49.7, respectively. Output remained above 50.0 but decreased in the month to 51.9 ([Fig. 2](#)).

(4) *Exports.* China's merchandise exports fell 1.0% y/y during August ([Fig. 3](#)). One of the larger contributors to the decline was exports to the US, which dropped 16.0% y/y. China's merchandise exports to the US as a share of its total exports has fallen to 16.6% from 19.6% a year ago.

Slowdowns in exports have become apparent in tariff-sensitive industries. For example, [according](#) to the SCMP, over 500 companies in an eastern Chinese city known for its textile production exported 28% less in the first four months of 2019 versus the comparable period last year. Woven fabric is included on the list of \$200 billion Chinese goods covered by the 25% tariffs imposed by the US.

(5) *Retail sales.* Domestically, Chinese consumer spending growth is slowing. Chinese retail sales growth slowed to 7.5% y/y in August from a recent high of 9.8% in June. Inflation-adjusted retail sales growth is down to 4.7%, trending lower along with the growth of industrial production.

If slowing consumer purchases are tied to the country's growing household debt burden (as discussed below), then more stimulus from the government may do little to solve the problem. The aging of China's population, another not easily solved structural issue, is likely showing in these data too ([Fig. 4](#) and [Fig. 5](#)).

China III: Litany of Woes. Those are some of the structural problems weighing on China's economic growth along with corroborating data. Here are excerpts from recent articles Melissa and I have found that drill more deeply into these challenges:

(1) *Demographics.* "[Burying 'One Child' Limits, China Pushes Women to Have More Babies](#)," appeared

in the 11/11/18 *NYT*. “Almost three years after easing its ‘one child’ policy and allowing couples to have two children, the government has begun to acknowledge that its efforts to raise the country’s birthrate are faltering because parents are deciding against having more children. Officials are now scrambling to devise ways to stimulate a baby boom, worried that a looming demographic crisis could imperil economic growth—and undercut the ruling Communist Party and its leader, Xi Jinping. ... The new campaign has raised fear that China may go from one invasive extreme to another in getting women to have more children. Some provinces are already tightening access to abortion or making it more difficult to get divorced.”

According to the article, the government is considering replacing the two-child limit with no limit. “The proposal is politically fraught” because it reminds people of the disastrous one-child policy imposed by the government. One of the terrible consequences of that policy is that there aren’t enough women to have babies because it caused far more boys than girls to be raised, resulting in a gender-imbalanced society: “The number of women between the ages of 20 and 39 is expected to drop by more than 39 million over the next decade, to 163 million from 202 million ...” (For an even deeper dive into the social havoc wreaked by this policy, read [Wanting a Daughter, Needing a Son](#).)

(2) *Fiscal & monetary policies*. “[China’s Stimulus Muddle Deepens](#)” appeared in the 3/5 *WSJ*. “Li Keqiang, China’s premier, has a few ideas for 2019: keep overall debt growth in check, cut taxes, accelerate government bond issuance, and boost lending to small businesses. If that sounds like a lot to ask—and contradictory—it is.

“Some of these goals will fall by the wayside. Getting banks to lend more to small businesses without overall credit growth accelerating will be near impossible. And significantly higher government debt sales will require more banking system liquidity to keep rates from rising and further damaging growth. That means more monetary easing: probably not a 2015-like flood, but definitely a rising tide. Beijing rightly recognizes that its two previous rounds of stimulus in the past decade, funded largely off the government’s books through state bank loans to state-owned enterprises, created a lot of bad debt for the buck.”

(3) *Total debt*. “[China’s total debt rises to over 300 per cent of GDP as Beijing loosens borrowing curbs to boost growth](#)” appeared in the 7/17 *SCMP*. “China’s total debt burden rose strongly in the first quarter of 2019 as Beijing allowed more loans and local government bond issuance to help shore up the slowing economy, according to estimates by the Institute of International Finance. The figure stood at nearly 304 per cent of its gross domestic product (GDP) in the first three months of the year, up from 297 per cent a year earlier, the US-based trade association said.”

“China launched a deleveraging campaign more than two years ago aimed at reducing debt and reining in risky lending, but as its economy has slowed due to the impact of the trade war with the United States, the government has eased credit conditions and posted fiscal spending on infrastructure projects to support economic growth.”

(4) *Household debt*. “[China’s household debt has grown so much that trade war stimulus is largely ineffective, study shows](#)” appeared in the 8/7 *SCMP*. “China’s household debt has risen to a such a high level that government stimulus designed to boost consumer spending would likely be ineffective, an international research group said. The country’s household debt-to-income ratio rose to 92 per cent at the end of last year, a sharp increase from only 30 per cent in 2008, the Washington-based Institute of International Finance (IIF) wrote in a research note. The ratio is higher than the 86 per cent in Germany and close to the levels of 97 per cent in the United States and 100 per cent in Japan.”

(5) *Depressed banks*. “[World’s Biggest Banks Sink to Record Lows as China Pain Spreads](#),” appeared

on the 8/4 Bloomberg. The article observed that investors recently dragged down valuations of China's largest banks because they expect that the large banks will be forced by the state to bail out smaller peers. That's just one indication that it's not only China's economy that's in trouble but the global financial system as well.

The plight of the banks "has been a major focus of investors since May, when Beijing surprised markets by seizing control of Baoshang Bank Co. in the first government takeover of a Chinese lender in two decades. That was followed two months later by a capital injection into Bank of Jinzhou Co. by ICBC and two other state-owned financial firms."

The Fed: The Cases for Zero, 25, and 50. The Federal Open Market Committee (FOMC) is widely expected to lower the federal funds rate range this week by 25bps to 1.75%-2.00%. We agree with that consensus view, seeing greater chance of a 25bps cut than the alternatives of no cut or a bigger, 50bps one. Here's our thinking:

(1) *The case for zip.* The global "crosscurrents" behind the last rate cut, of 25bps on 7/31, have dissipated. Fed officials worried that these issues would have a depressing spillover effect on US consumer confidence as well as business confidence and investment. In recent weeks, US-China trade negotiations are back on track, China hasn't resorted to military force in Hong Kong, and a no-deal Brexit may yet be avoided. In the US, CPI inflation has warmed up, while retail sales and industrial production figures have been strong.

In other words, without these crosscurrents, it's not clear that another rate cut this soon is appropriate.

(2) *The case for 25bps.* The financial markets are expecting a 25bps cut. If it doesn't happen, the credibility of the Fed's messaging could be impaired. Fed officials can still justify a small cut by observing that business spending remains weak and the PCED inflation rate is still below their 2.0% target. They could also indicate that they are doing it to stop the inversion of the yield curve.

(3) *The case for 50bps.* In the old days, a crisis in the Middle East, especially one that hit Saudi oil output, would have sent oil prices soaring—boosting global inflation and depressing global economies. Now global-oil-demand growth is slow, while there is relatively ample capacity for the US and Russia to increase supplies to offset the loss of Saudi oil until it is restored, which may happen fairly soon in any case. The FOMC would be hard-pressed to justify a 50bps rate hike on "uncertainties" created by the attack on Saudi oil output. In other words, there really isn't a case for a 50bps cut, as was thought possible during the late summer.

CALENDARS

US. Wed: Housing Starts & Building Permits 1.250mu/1.336mu, MBA Mortgage Applications, FOMC Rate Decision 1.75%-2.00%, FOMC Economic Projections, Powell. **Thurs:** Jobless Claims 213k, Existing Home Sales 5.37mu, Philadelphia Fed Manufacturing Index 11.0, EIA Natural Gas Storage. (DailyFX estimates)

Global. Wed: Eurozone Headline & Core CPI Final 1.0%/0.9% y/y, Eurozone Trade Balance, UK Headline & Core CPI 1.9%/1.7% y/y, Canada CPI 0.2% m/m/1.7% y/y. **Thurs:** UK Retail Sales Total & Ex Fuel 2.9%/2.6% y/y, UK BOE Rate Decision 0.75%, UK BOE Asset Purchase Facility £435b, Japan CPI Core 0.5% y/y, Japan BOJ Rate Decision -0.10%, Australia Employment Change & Unemployment Rate 10k/5.3%, RBA Bulletin, Coeure, Lautenschlager. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Buybacks ([link](#)): S&P 500 quarterly buybacks tumbled 20.1% q/q to a six-quarter low of \$164.5 billion during Q2-2019. Buybacks were down for a second straight quarter to 26.2% below the record high of \$223.0 billion during Q4-2018. The \$164.5 billion reading is still the seventh highest quarterly buyback amount on record, dating back 86 quarters to Q1-1998, but is now 4.3% below the prior cycle's record high in Q3-2007. The four-quarter sum of buybacks was down for the first time since Q2-2017, falling 3.2% q/q to \$797.0 billion from a record high of \$823.2 billion in Q1-2019. S&P 500 buybacks in Q2 fell to a six-quarter low of 0.67% of the total market capitalization for the S&P 500. That compares to 0.87% during Q1, a 29-quarter high of 1.06% in Q4-2018, and the record high of 1.28% during Q3-2007.

S&P 500 Sectors Buybacks ([link](#)): Buybacks rose q/q during Q2-2019 for just three of the 11 sectors and fell for eight. That's the same count as Q1-2019, which was a complete reversal of the eight rising and three falling during Q4-2018. The q/q gainers among the 11 sectors during Q2-2019: Real Estate (up 35.8% q/q to \$554.9 million from \$408.5 million), Communication Services (12.4%, to \$7.1 billion from \$6.3 billion), and Energy (6.0%, to \$4.6 billion from \$4.3 billion). The q/q decliners: Materials (-49.3%, to a five-quarter low of \$2.4 billion from \$4.8 billion), Health Care (-44.5%, to \$17.1 billion from \$30.7 billion), Utilities (-40.4%, to \$882 million from \$1.5 billion), Consumer Staples (-27.3%, to \$7.1 billion from \$9.8 billion), Information Technology (-20.3%, to a six-quarter low of \$54.2 billion from \$68.0 billion), Industrials (-12.7%, to \$17.0 billion from \$19.4 billion), Financials (-11.7%, to \$37.8 billion from \$42.8 billion), and Consumer Discretionary (-11.0%, to a 24-quarter low of \$15.8 billion from \$17.8 billion). Tech accounted for the biggest portion of total S&P 500 buybacks in Q2-2019 for a seventh straight quarter, remaining steady q/q at a 33.0% share. Tech had held the top spot for 16 straight quarters through Q3-2016 before trading places with Financials and Health Care for four quarters through Q3-2017. Financials' share was second for a fourth straight quarter, as it improved to 23.0% from 20.8% in Q1.

S&P 500 Cash Return & Buyback Yield ([link](#)): During Q2-2019, the S&P 500 companies continued their long-established trend of spending more on buybacks than dividends, as buybacks of \$164.5 billion outpaced the quarterly dividend payments of \$118.2 billion. Buybacks have exceeded dividends in 55 of the past 60 quarters back to Q3-2004, except during the financial crisis from Q4-2008 to Q4-2009, when all sectors cut buyback spending drastically. With the pace of buybacks falling in Q2, the four-quarter sum of buybacks and dividends, or cash returned to investors, fell for the first time in eight quarters to \$1.266 trillion from a record high of \$1.285 trillion during Q1. The S&P 500's buyback yield fell to 3.26% from 3.48%, and is down from a 29-quarter high of 3.84% in Q4-2018. The dividend yield edged down to 1.92% from 1.96%. Adding both Q2 figures together, the buyback + dividend yield (or cash return) dropped to a three-quarter low of 5.18% in Q2 from 5.44% in Q1, and is down from a 29-quarter high of 6.00% during Q4-2018.

S&P 500 Sectors Cash Return & Buyback Yield ([link](#)): During Q2-2019, the four-quarter buyback + dividend yield rose q/q for just 3/11 sectors. Here's how they ranked: Financials (7.34%), Tech (6.45), Energy (5.49), Industrials (5.20), S&P 500 (5.18), Consumer Staples (4.93), Consumer Discretionary (4.46), Health Care (4.41), Materials (4.33), Communication Services (3.65), Real Estate (3.56), and Utilities (3.56). Here's how they ranked just by their dividend yield as just two sectors improved q/q and 8/11 sectors were ahead of the S&P 500: Energy (3.47%), Real Estate (3.16), Utilities (3.11), Consumer Staples (2.87), Communication Services (2.32), Financials (2.11), Materials (1.98), Industrials (1.94), S&P 500 (1.92), Health Care (1.71), Information Technology (1.38), and Consumer Discretionary (1.30). Looking solely at their buyback yield, just three sectors improved q/q, and only two were ahead of the S&P 500. Here's how they ranked according to their buyback yield: Financials (5.23%), Information Technology (5.06), S&P 500 (3.26), Industrials (3.26), Consumer Discretionary (3.17), Health Care (2.70), Materials (2.35), Consumer Staples (2.06), Energy (2.02), Communication

Services (1.33), Utilities (0.46), and Real Estate (0.40).

US ECONOMIC INDICATORS

Industrial Production ([link](#)): Some signs of life in industrial production are now emerging, after declines the first four months of this year. Output climbed for the third time in four months in August, by 0.6% m/m (the biggest gain this year) and 0.8% over the period; production had declined 1.5% during the four months through April—after reaching a new record high at the end of last year. Manufacturing production is up nearly 1.0% over the four months through August, following a 2.0% slump the first four months of this year. Output of business equipment is up 1.5% over the four-month span, with industrial (1.7%), information processing (1.3), and transit (1.0) equipment all climbing—with information processing at a record high. Consumer goods production is up 1.4% over the four-month period, led by a 3.5% surge in durable goods; consumer nondurable goods output advanced a more subdued 0.8%. Mining output remains volatile at record highs, rebounding 1.4% in August after falling 1.5% in July; utilities output is up 4.3% since falling to a 16-month low in June. August's M-PMI (50.3) continued to tread water, holding just above the breakeven point of 50.0 for the fourth month.

Capacity Utilization ([link](#)): The headline capacity utilization rate rose for the first time this year in August, after falling to a 21-month low in July, climbing from 77.5% to 77.9%. It was 1.9ppts below its long-run (1972-2018) average. Manufacturing's rate remains volatile around recent lows, climbing from 75.4% to 75.7%—2.6ppts below its long-run average. The utilization rate for mining moved up to 90.5%, slightly below its average in the three months before Hurricane Barry though 3.4ppts higher than its long-run average. The rate for utilities increased from 76.4% to 76.7%, but remained well below its long-run average.

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