Yardeni Research

**MORNING BRIEFING**
**April 15, 2021**

## China Trouble

*Check out the accompanying chart collection.*

(1) Waking up to China's hostile agenda. (2) China's military might is on show on the South China Sea and near Taiwan's airspace. (3) Hong Kong is officially under China's thumb. (4) CEOs learn to bite their tongues to do business in China. (5) Foreign CEOs may soon find they need to pick sides. (6) Hackers and spies and lies—oh, my! (7) Chinese stocks had a great 2020, but tough start to 2021. (8) A digital yuan could push US pols and regulators to get moving on a digital dollar.

**China: Ominous Actions and Words.** The first step toward fixing a problem is acknowledging the problem exists. And it looks like the US government, its allies, and business leaders are finally ready to admit that the People's Republic of China (PRC) under the leadership of the Chinese Communist Party is officially a problem. The country's quick rebound from Covid-19—and the US's muddled response to the virus—appear to have emboldened China's leaders to grow more aggressive on both the world stage and in the business world.

The PRC's military ships are parading around the South China Sea like they own the neighborhood, and its aircraft are flying ominously near Taiwan almost daily. The PRC has broken its agreement to allow Hong Kong to maintain its capitalist system and way of life until 2047 by installing its own leaders in Hong Kong and eliminating the city's free speech. The PRC has even grown so bold as to punish US and multinational companies that dare call out the nation's crimes against humanity, particularly inflicted on its Muslim minority in Xinjiang. And China's leaders, notably its foreign diplomats, aren't even pretending to want compromise on contentious issues. They apparently have decided it's China's turn to take the lead in world affairs.

If there's a positive in China's recent actions, it's that they have served as a bucket of ice water, waking up the world to the ambitions of communist dictator President Xi Jinping. This new awareness should make turning a blind eye to the PRC's behavior difficult, despite the profits derived from cheap manufacturing or sales to the country's 1.4 billion citizens. It should accelerate the US government's efforts to bring the manufacturing of essential items—like pharmaceuticals, personal protection equipment (PPE), and rare earth metals—back to our country. And it should help President Joe Biden create coalitions with other nations to push back against the PRC's actions.

Here's Jackie's look at some of the PRC's recent eye-opening actions:

(1) *War games on the sea and in the air.* China's military has grown extremely aggressive this year, showing its muscle to neighboring nations as it sails through disputed waters and flies too close to Taiwan for comfort. On Wednesday, China's military began six days of combat drills in the waters off of Taiwan's coast. The drills coincide with the arrival of a US delegation to Taiwan that was described as a "personal signal" of President Biden's commitment to Taiwan.

Chinese military aircraft have been flying near Taiwan's airspace almost daily this year. The largest show of force occurred Monday, when the PLA flew 25 warplanes into Taiwan's air defense identification zone (ADIZ). (An ADIZ is not considered a country's airspace but the area around it in which the country is allowed to identify, locate, and control approaching foreign aircraft so that it will have enough time to respond if it determines the aircraft is a threat.)

Chinese drones have been circling the Taipei-controlled Pratas Islands in the South China Sea. Taiwan threatened to shoot if the drones flew into restricted airspace. Though unoccupied, the islands are close to Hong Kong and could serve as stepping stones if China decided to invade Taiwan.

Last month, more than 200 Chinese ships anchored around the Whitsun Reef, an area in the South China Sea claimed by Vietnam and the Philippines. It's near many of the islands that China created or expanded by dredging sand up from the sea's floor. Many of the ships since have left. The Philippines government said the ships are a Chinese maritime militia, but the Chinese government claims they're merely civilian fishing boats "sheltering from the wind," an April 6 *South China Morning Post* (*SCMP*) article reported.

China's military ships have visited the waters near Japan, too. An aircraft carrier and other military ships sailed through a strait running between Japan's Okinawa and Miyako islands heading toward the Pacific on April 3. This follows Chinese ships that entered waters near the Japanese-controlled Diaoyu Islands as frequently as twice a week in March. The actions occurred after the PLA's new coastguard law went into effect in February. It allows "quasimilitary ships to use weapons against foreign ships that Beijing sees as illegally entering its waters," an April 5 *SCMP* article explained.

The US responded by sending a US aircraft carrier strike group to the South China Sea through the Strait of Malacca on April 4. A US-guided missile destroyer was also operating in the East China Sea close to China's Yangtze River. And the US has started working with Australia, Japan, and India—the "Quad" countries—in an effort to counter China's influence. The four countries and France held three days of naval exercises in the Bay of Bengal starting on April 5.

The US military is concerned that China's more aggressive stance in the South China Sea and its continued military buildup signal that the country might attack Taiwan. "We have indications that the risks are actually going up," Admiral Philip Davidson, the most senior US military commander in the Asia-Pacific region told a Senate panel last month, according to an April 7 Associated Press article. "The threat is manifest during this decade—in fact in the next six years."

The Biden administration hasn't gone so far as to end the longstanding US policy of "strategic ambiguity" on Taiwan's nationhood by formally recognizing it as a nation, but it has unambiguously reaffirmed the US's commitment to Taiwan's independence. Secretary of State Antony Blinken said on Sunday: "We have a commitment to Taiwan under the Taiwan Relations Act, a bipartisan commitment that's existed for many, many years, to make sure that Taiwan has the ability to defend itself, and to make sure that we're sustaining peace and security in the Western Pacific. We stand behind those commitments," according to an April 11 Politico article. "[I]t would be a serious mistake for anyone to try to change the existing status quo by force."

(2) *Clamping down on Hong Kong.* When the UK turned control of Hong Kong over to China in 1997, Hong Kong's capitalistic system and freedoms were supposed to be protected through 2047 by the Sino-British Joint Declaration. But over the past year, the PRC has changed the laws in Hong Kong to squash Hong Kong citizens' voting rights and essentially end free speech.

Last June, Beijing imposed a new national security law to eliminate any sign of opposition to Beijing rule, including street protests. The law prohibits secession, subversion, terrorism, and collusion with foreign or external forces, a June 30 BBC article explains. Cases can be tried on the mainland, and punished by life in prison. The law allows Beijing to set up a security office in Hong Kong, with its own personnel. Some fear Beijing will use the national security law to attack Hong Kong's independent court system, as the law grants Beijing power over how laws should be interpreted, allows closed-door trials, and permits Hong Kong's chief executive to appoint judges to hear national security cases.

Since the law was enacted, the raucous protests have ground to a halt, and protesters have been jailed, gone underground, or fled the city. The law's reach soon will be tested by the opening of a new modern art museum in Hong Kong, M+. Among its extensive collection are works by Chinese dissident artist Ai Weiwei, prohibited from display in China. Debate is raging over whether the new law is breached by some of Ai's artwork (like a photo featuring his "upturned middle finger aimed squarely at the Gate of Heavenly Peace in the Chinese capital," according to an April 6 *SCMP* article).

The PRC also weakened Hong Kong's democracy by restructuring its Legislative Council. New election laws expand Hong Kong's Legislative Council to 90 members from 70. Though larger, the body is less representative of the people because the percent of seats elected by Hong Kong residents drops to 22% (20 of 90) from 50% (35 of 70). In addition, the Hong Kong police force's national security arm will assess whether candidates "comply with legal requirements that include demonstrating loyalty to the city and upholding its miniconstitution," a March 30 *WSJ* article reported. A new government panel will review the police assessments and rule on the eligibility of the potential candidates. The new election rules were approved unanimously by the Chinese legislature's standing committee meeting in Beijing, the *WSJ* article noted.

(3) *Businesses may need to pick a team.* The most surprising move by the Chinese government has been its recent aggressive posture toward corporations—those headquartered in China and abroad. Apparently, the nation's desire to attract companies offering jobs and technology has been replaced by the PRC's need for corporations to play by the nation's rules, especially those regarding speech.

In October, China's most famous billionaire Jack Ma, founder of both Ant Group and Alibaba, accused Chinese financial regulators of outdated, overly risk-adverse policies that stifle innovation. Swift and expensive retaliation ensued: Regulators pulled the plug on Ant's planned $34 billion IPO in November, dashing what would have been a crowning achievement for the company and the nation. This week, Ant announced it would apply to become a financial holding company overseen by China's central bank, a move that will likely slow its growth.

Ant "will have to correct what regulators called unfair competition in its payments business and improve its corporate governance. [It] will have to reduce the liquidity risks of its investment products and shrink the assets under management of Yu'e Bao, its giant money-market mutual fund. Ant will also be required to break an 'information monopoly' on the vast and detailed consumer data it has collected," an April 12 *WSJ* article reported.

Separately, Alibaba was fined a record $2.8 billion after an anti-monopoly investigation found it was punishing companies that sold on both Alibaba and rivals' platforms. But Alibaba's shares rose after news of the fine's lower-than-expected amount.

The Chinese government has punished foreign companies as well. Swedish clothing retailer H&M said last year that it didn't source products from the Xinjiang region because H&M prohibits forced labor in its supply chain. In March, the Chinese state and social media reacted angrily to H&M's comments, accusing the company of spreading rumors and smearing China, a March 24 *WSJ* article reported. The company's name disappeared from China's biggest e-commerce platforms, and there were calls on social media to boycott the company. There were also calls to boycott products from Nike and Adidas, which have pledged not to use Xinjiang cotton.

Hopefully, these events have opened the eyes of the business community both in the US and in China. Why start a business in China if it could disappear overnight because you said the wrong thing?

(4) *Not playing by the rules.* The Chinese government doesn't always play by the same rules that govern business or politics in the West. The most recent and stunning example is the PRC's failure to give World Health Organization (WHO) officials enough access to Chinese facilities and information to determine the source of Covid-19. China retorted by suggesting WHO investigators examine the US military biological lab Fort Detrick, without providing any evidence that Covid-19 was created there.

Chinese hackers certainly aren't playing by the rules. In January, they reportedly broke into Microsoft's Exchange Server systems and infected as many as 20,000 of the company's customers' systems. In 2015, Chinese hackers broke into the US office of Personnel

Management's systems, stealing millions of government background investigation records, dating back 20 years, that contained detailed information on current and former US government employees and their families, an April 7 *WSJ* article reported. Chinese hackers also are believed to be behind the hacks of Marriot International and Equifax computer systems.

Over the last two or three years, the Department of Justice has brought many cases against Chinese nationals who have come to the US to steal trade secrets from US companies and universities. Unfortunately, in our digital age, copying information is as easy as taking a picture of a computer screen, inserting a USB drive, or sending an email. Many of the accused hid their affiliation with the Chinese military.

Given this dubious track record, it's highly unlikely that China and its businesses will honestly report environmental, social and governance (ESG) factors. Companies listed in Hong Kong are required to list ESG factors that are material to the business already, and those listed on Chinese stock exchanges will be required to do so by year-end. But if ESG disclosures aren't vetted by western auditors, investors won't be able to weigh ESG matters when deciding between investments in US and China.

An April 12 *Financial Times* article told of a company in Tangshan, heart of the country's steel industry, that was discovered to have faked records to dodge emissions targets. To China's credit, the violator was caught by the country's environmental minister, who made surprise inspections during a period of heavy smog in Beijing. But the anecdote also underscores the apparent lack of compunction about breaking environmental regulations on the part of some Chinese companies.

(5) *A look at China's markets.* China's stock market was among the first to recover from the Covid-19 pandemic, and now may be among the first to lose steam. The China MSCI stock price index in dollars rose 27.3% last year, making it the fourth best-performing stock market in the world, trailing only Korea, Denmark, and Taiwan. This year, the MSCI China stock index has faltered, dropping 0.4% ytd through Tuesday's close (*Fig. 1*).

Investors apparently fear that the Chinese central bank may soon withdraw monetary support, as the country's economy grew in the last three quarters of 2020, with Q4 real GDP clocking in at 6.5% y/y (*Fig. 2*). The country's manufacturing purchasing managers index has been above

50 since last February and was 51.9 in March (*Fig. 3*). Likewise, China's retail sales have been growing since August and rose 4.6% y/y in December (*Fig. 4*).

Just as occurred in the US, the Chinese government supported its economy during the Covid-19 pandemic, leading China's total social financing to surge by $5 trillion (12-month sum), a 24% y/y increase (*Fig. 5*). China's bank loans are also near a record high at $3.1 trillion (12-month sum), up 20% y/y (*Fig. 6*). The Chinese central bank is expected to reduce credit growth now that the economy is on solid footing.

Analysts remain optimistic about Chinese companies' growth prospects. Companies in the China MSCI index are expected to grow revenues by 15.3% this year and 9.6% in 2022 (*Fig. 7*). Earnings are expected to grow slightly faster: 17.8% this year and 17.0% in 2022 (*Fig. 8*). The market's forward P/E is 16.0, high relative to the past 20 years but off from 18.3 a few months ago (*Fig. 9*).

**Disruptive Technologies: Chinese Introduce Digital Yuan.** China's central bank is rolling out a digital yuan, making it the first central bank to issue a central bank digital currency (CBDC). A digital currency is less expensive to produce and store than hard currency and makes transactions easier, faster, and cheaper. Besides offering citizens convenience, the CBDC offers the government another way to track them—including what citizens earn, what they spend, and where they go.

While the US central bank has studied digital currencies, it doesn't look like one will hit our markets anytime soon. "To move forward on [a central bank digital currency], we would need buy-in from Congress, from the administration, from broad elements of the public, and we haven't really begun the job of that public engagement," said Fed Chairman Jerome Powell, according to a March 22 CNBC article. "So, you can expect us to move with great care and transparency with regard to developing a central bank digital currency."

That said, China's recent aggressive actions combined with its digital yuan announcement may have lit a fire under US politicians. The Biden administration is reportedly "stepping up scrutiny" of China's digital yuan plans, concerned they might be part of a long-term plan to dethrone the dollar as the world's reserve currency, an April 12 Bloomberg article reported.

If other nations adopt digital currencies, those countries could transact outside of the SWIFT payment system, which allows the US and its allies to enforce sanctions. Thailand, for one, is testing a retail digital currency next year with implementation targeted in the next three to five years. Japan also began experimenting with a digital currency, an April 6 CNBC article reported. And central banks from China, Thailand, United Arab Emirates, and Hong Kong are exploring a digital currency cross-border payment project.

## CALENDARS

**US:** **Thurs:** Retail Sales Total & Ex Autos 5.9%/5.0%, NY & Philadelphia Fed Manufacturing Indexes 19.542.0, Headline & Manufacturing Industrial Production 2.8%/4.0%, Capacity Utilization Rate 75.7%, Business Inventories 0.5%, Initial & Continuous Jobless Claims 700k/3.7m, NAHB Housing Market Index 83, EIA Natural Gas Inventories, Bostic, Daly, Mester. **Fri:** Housing Starts & Building Permits 1.613mu/1.750mu, Consumer Sentiment Index Total, Current Conditions, and Expectations 89.6/96.3/83.6, Baker-Hughes Rig Count. (DailyFX estimates)

**Global:** **Thurs:** Germany CPI 0.5%m/m/1.7%y/y, France CPI 1.1% y/y, Italy CPI 0.8%y/y, China GDP 1.5%q/q/18.9%y/y, China Industrial Production & Retail Sales 17.2%/28.0%, UK BOE Credit Conditions Survey, Mauderer. **Fri:** Eurozone Headline & Core CPI 1.3%/0.9% y/y, Cunliffe. (DailyFX estimates)

## STRATEGY INDICATORS

**Stock Market Sentiment Indicators** (*link*): The Bull/Bear Ratio (BBR) moved further above 3.00 this week, as bullish sentiment moved further above 60.0%. The BBR climbed for the fifth week to 3.77 this week, after dropping the prior three weeks from 3.27 to 2.48—which was the lowest since early April. Bullish sentiment rebounded for the second week to 63.4% this week—close to its cycle peak reading of 64.7% during late November 2020—after retreating to 54.4% two weeks ago. Most of the two-week 9.0ppts move up in bullish sentiment came from the correction camp, as its percentage sank 8.3ppts (to 19.8% from 28.1%) over the time span. Bearish sentiment inched up to 16.8% after dropping 3.9ppts (to 16.7% from 20.6%) the prior four weeks. The AAII Ratio rebounded to 73.6% last week (the highest since January 2018), after dropping from 71.2% to 66.4% the previous week, as bullish sentiment rose from 45.8% to 56.9% (the highest since January 2018) and bearish sentiment fell from 23.2% to 20.4%.

**S&P 500 Earnings, Revenues, Valuation & Margins** (*link*): The S&P 500's forward profit margin remained steady at 12.2% this week. That's its highest level since December 2018. Forward revenues and earnings have been making new record highs since the beginning of

March and for the first time since February 2020. The rapid pace of Covid-19 estimate cuts during the first half of 2020 has turned into a V-shaped recovery as analysts play catch-up from their lowball estimates prior to the better-than-expected earnings seasons since Q2-2020. Consensus S&P 500 forecasts had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues growth rose 0.1ppt w/w to 8.6%, down from a record high of 9.0% in mid-February. Forward revenues growth has come a long way from the 0.2% to which it had dropped in April 2020, which was the lowest reading since June 2009. Forward earnings growth gained 0.2ppts w/w to 21.9%. It had been at 22.8% at the end of January, its highest level since July 2010 and up substantially from its record low of -5.6% at the end of April. Analysts expect revenues to rise 9.7% in 2021 and 6.7% in 2022 compared to the 2.2% decline reported in 2020. They expect an earnings gain of 27.6% in 2021 and 14.9% in 2022 compared to a 13.3% decline in 2020. The forward profit margin of 12.2% is up 1.9ppts from 10.3% during April, which was the lowest level since August 2013. It's still down 0.2ppt from a record high of 12.4% in September 2018. Analysts expect the profit margin to rise 1.7ppt y/y in 2021 to 11.9%—from 10.2% in 2020—and to improve 0.9ppt y/y to 12.8% in 2022. Valuations rose strongly last week. The S&P 500's weekly forward P/E was up 0.6pt w/w to 22.3 and compares to a 17-week low of 21.3 at the beginning of March. That also compares to 23.1 in early September, which was the highest level since July 2000 and up from a 77-month low of 14.0 in mid-March. The S&P 500 price-to-sales ratio gained 0.07pt w/w to a new record high of 2.72, which compares to its 49-month low of 1.65 in March 2020.

**S&P 500 Sectors Earnings, Revenues, Valuation & Margins** (*link*): Last week saw consensus forward revenues and earnings rise w/w for eight of the 11 S&P 500 sectors. Consumer Staples and Utilities had both measures tick lower w/w while Industrials' and Materials' were mixed. Forward P/E ratios for nearly all sectors now are back above their record or cyclical highs prior to the Covid-19 bear market. During 2019, just two sectors' margins improved y/y: Financials and Utilities. Consumer Staples, Tech, and Utilities were the only sectors with an improved profit margin in 2020. For 2021, all but Real Estate and Utilities are expected to improve y/y. Back in 2018, the forward profit margin was at record highs for 8/11 sectors, all but Energy, Health Care, and Real Estate; since then, it has moved lower for nearly all the sectors. The forward profit margin rose for two of the 11 sectors last week and fell for one. Three sectors were at record highs: Materials, Tech, and Utilities. Real Estate's has been improving since December's lowest level since January 2012, and Energy's is up from its record low in April 2020. Here's how the sectors rank based on their current forward profit margin forecasts versus their highs during 2018: Information Technology (23.6%, a new record high), Financials (17.9, down from 19.2), Communication Services (14.8, down from 15.4), Utilities (14.8, record high), Real Estate (13.9, down from 17.0), S&P 500 (12.2, down from 12.4), Materials (11.7, record high), Health Care (10.9, down from 11.2), Industrials (9.0, down from its record high of 10.5% in mid-December), Consumer Staples (7.6, down from 7.7), Consumer Discretionary (6.9, down from 8.3), and Energy (5.6, down from 8.0).

**S&P 500 Sectors Forward Revenues and Earnings Recovery from Covid-19 Trough** (*link*): The S&P 500's forward revenues and earnings as well as its implied forward profit margin bottomed at cyclical lows on May 28 after 14 weeks of Covid-19-related declines. Forward revenues and earnings have risen 10.1% and 31.3%, respectively, since then to new record highs. The forward profit margin has risen 2.0pt to a 27-month high of 12.2%. During the latest week, all 11 sectors posted gains in either their forward revenues, earnings, or profit margin. Materials and Energy have been particularly strong in recent weeks and have moved up in the forward revenues performance leaderboard. Here's how the 11 sectors rank by their changes in forward revenues and forward earnings since May 28: Materials (forward revenues up 15.2%, forward earnings up 52.8%), Information Technology (14.9, 24.4), Communication Services (14.7, 27.1), Energy (12.1, 1000.9), Industrials (12.0, 38.1), Financials (11.2, 47.3), S&P 500 (10.1, 31.3), Health Care (9.7, 19.3), Consumer Staples (5.3, 12.3), Consumer Discretionary (3.9, 54.2), Real Estate (3.1, 1.0), and Utilities (-2.2, 4.0). Tesla's addition to the S&P 500 on December 21 caused revenue and earnings forecasts to fall for the index and the Consumer Discretionary sector. Before then, S&P 500 revenues were up 7.1% and earnings 19.6%. The similar readings for Consumer Discretionary then were 11.2% and 39.7%, which would have ranked the sector first in the revenues derby instead of near the bottom.

## US ECONOMIC INDICATORS

**Import Prices** (*link*): Import prices have heated up the past five months, climbing 1.2% in March and 5.2% over the period, after changing little the prior three months. Prices are up 9.7% since bottoming last April, pushing the yearly rate (6.9% y/y) up to its highest reading since January 2012. Before turning positive this January (+1.0% y/y), the yearly rate was negative for 11 successive months. Petroleum prices were a big contributor to both the March and five-month gain in overall import prices—jumping 6.7% and 44.8% over the respective periods. However, nonpetroleum prices rose 0.9% and 2.7% over the same periods, pushing this yearly rate up to 4.1%—the highest since October 2011. The rate for industrial supplies & materials imports (29.5% y/y) accelerated to its highest reading since September 2011 (after turning positive for the first time in a year in January), while the rate for food prices (3.8) accelerated sharply recently after hovering around zero for four months. The rate for consumer goods ex autos (0.6% y/y) moved further into positive territory, while autos' (1.1) remained in a flat trend around 1.0%. Meanwhile, the rate for capital goods (1.3% y/y) continued to hold around 1.0%, up from November 2019's bottom of -2.0%. Import prices are picking up among our trading partners, with import prices for goods from the EU (4.8% y/y) accelerating to its highest rate since the end of 2011, while China (1.8% y/y) posted its highest yearly gain since spring 2012. The rate for the NICs (3.7% y/y) was the highest since mid-2018, while the rate for Japan (0.9) remained near zero, but is accelerating, posting its highest rate since December 2018.

## GLOBAL ECONOMIC INDICATORS

**Eurozone Industrial Production** (*link*): Output dipped in February and is currently stalled 1.4% below its pre-pandemic level. February's decline was the second shortfall in three months and since last April. Industrial production contracted 1.0% in February after a 0.8% gain and a 0.1% loss the prior two months, following a seven-month surge of 36.6%. Manufacturing production fell 1.0% in February following a 0.7% increase and a 0.2% decrease the previous two months after a seven-month jump of 40.2%. All the main industrial groups were in the red during February: capital goods (-1.9%), energy (-1.2) consumer durable goods (-1.1), intermediate goods (-0.7), and consumer nondurable goods (-0.1). Here's a look at how the main industrial groups fared during the ten months through February and where they stand relative to their pre-pandemic levels: consumer durable goods (+108.5% & -0.3%), capital goods (+63.6 & -2.1), intermediate goods (+34.9 & +0.7), consumer nondurable goods (+11.5 & -4.1), and energy (+8.8 & -0.7). Here's the same exercise for total production among the top four Eurozone economies: Italy (+71.8% & -2.3%), Spain (+45.1 & -2.4), France (+43.0 & -5.0), and Germany (+31.9 & -4.9). For the month of February, production in the top four Eurozone economies was mixed. Industrial production (ex construction) for Italy expanded for the third month, by 0.2% m/m and 1.5% over the period, while Spain's held steady after a 0.7% loss and a 0.4% gain the prior two months. In the meantime, France's output contracted 4.8% after rebounding 3.4% during January, while Germany's fell 1.8% following January's 0.2% loss—the first declines since last April.

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