MORNING BRIEFING
December 9, 2021

China, Wall Street, and the CIA

Check out the accompanying chart collection.

(1) Evergrande's restructuring looks likely. (2) It's not alone. (3) Chinese economic growth slows, so its central bank boosts liquidity. (4) Hongkongers moving out. (5) Biden ires China by giving Taiwan a seat at the table and skipping the Olympics. (6) China building military outposts. (7) The little guys standing up to Xi might start a trend. (8) US financial giants see an opening in China and take it. (9) But are they hurting the US by developing China's markets? (10) Taking a look at the venture capital firm that invests the CIA's money. (11) Warning the US to up government research funding or risk losing our edge to China.

China: A Week of Headaches. We've always believed that actions speak louder than words. And no matter how often China's leadership says all's well, recent actions indicate otherwise. Evergrande, the country's largest property developer, took one step closer to bankruptcy this week. Hong Kong residents are heading for the exits, and some external organizations have started to call out China's tyranny. Let's review what's been a rough week for China's leadership:

(1) *Property sector unraveling.* Evergrande failed to pay on Monday an $82.5 million debt payment that will likely result in an official default that pushes the large property developer to restructure its debt. The news is not a surprise, with the price of Evergrande's dollar-denominated bonds below 20 cents on the dollar and the company's shares each trading south of HK$2.

It's widely known that Evergrande has roughly $300 billion in outstanding debt. Less understood are the guarantees the company has provided on other issuers' debt. This week, the company unexpectedly revealed that "it has been asked to honor a debt guarantee of around $260 million, without providing further details," a December 6 *WSJ* *article* reported.

Evergrande isn't the only property developer in China having problems. There have been 11 defaults this year, land sales have fallen 55% y/y, and housing sales dropped 25% in October, according to JPMorgan data cited in a December 7 Reuters *article*.

Some of the specific companies in trouble were discussed in a December 6 Reuters *article*. Kaisa Group Holdings saw trading in its shares suspended Wednesday after it announced that bondholders rejected an exchange offer; Kaisa has $11.6 billion of dollar-denominated bonds outstanding. Sunshine 100 China Holdings defaulted on a $170 million dollar bond on Monday. And creditors of China Aoyuan Property Group have demanded repayment of $651.2 million in response to credit-rating downgrades—which it may be unable to pay due to a lack of liquidity.

The property sector's problems appear to be weighing on the economy. The November manufacturing purchasing managers index came in at 50.1, just barely above the 50.0 mark indicating expansion; but a number of the index's components—including new orders (49.4) and employment (48.9)—were in contraction territory (*Fig. 1*). China's central bank responded by cutting the bank reserve requirement on Monday by 50bps, its second cut this year (*Fig. 2*).

(2) *Hongkongers hitting the road.* The exodus from Hong Kong continues in the wake of the Chinese government's changes to the city's laws and clampdown on citizens' freedoms. Nearly twice as many students and teachers have left 140 of Hong Kong's secondary schools in the 2020-21 school year, a December 5 *article* in the *South China Morning Post* (*SCMP*) reported. Commenting readers blamed the lack of freedom and Internet censorship in Hong Kong now that the city is under Chinese control.

Separately, a survey by Oxford University's Migration Observatory found that a third of British nationals living in Hong Kong are considering moving to the UK and 6% have already applied to do so. The survey polled 1,000 Hongkongers with British National (Overseas) status—which roughly 5.4 million of Hong Kong's 7.5 million residents have, a December 3 *SCMP* *article* reported. Respondents wanted to move to the UK, then Taiwan, Australia, and Canada.

(3) *US and China sparring.* The US is not winning any friends inside China by inviting Taiwan to the Summit for Democracy, a virtual gathering this week of more than 100 democratic governments. The move counters China's requirement that no country or company recognize the island as an independent nation. Zhao Lijian, a Chinese foreign ministry spokesman, warned: "Playing with the fire of 'Taiwan independence,' you will eventually get burned," a November 24 *WSJ* *article* reported.

The Biden administration followed that jab by announcing that administration officials won't be attending the Beijing Winter Olympics, citing the Chinese government's "ongoing genocide and crimes against humanity," referring to its treatment of Uyghur Muslims. Canada, the UK, and Australia followed the US's lead and also announced a diplomatic boycott of the games. Athletes of the nations, however, will attend the Olympics. China's Foreign Ministry said it would respond by taking "resolute countermeasures."

The US is also working to thwart China's attempts to expand its military presence around the world. Most recently, US diplomats have been trying to persuade Equatorial Guinea, on Africa's west coast, not to allow China to build a military base there, according to a December 5 *WSJ* article, even though Equatorial Guinea already has a Chinese-built deep-water port. China already has a military base in Djibouti, on the east coast of Africa. And it has been building a military base at a Chinese-run commercial port in the United Arab Emirates (UAE), which the Biden administration has lobbied the UAE to halt.

(4) *Finally taking a stand.* Companies, organizations, and even basketball stars have been quick to ask for forgiveness whenever they've insulted or criticized China or supported Taiwan. But recently, some smaller entities have shown backbone, which may embarrass larger organizations into following their lead in the future.

The US Women's Tennis Association (WTA) pulled all of its events out of China after it couldn't confirm the wellbeing of Peng Shuai, a former doubles player ranked number one in the world and three-time Olympian. She posted an online message that said she was sexually assaulted by China's former Vice Premier Zhang Gaoli and remains in China. Many elite tennis players supported both Peng and the WTA's actions.

NBA Celtics player Enes Kanter Freedom has been an outspoken critic of the Chinese government, calling President Xi Jinping a "brutal dictator" and wearing sneakers during games painted by a Chinese dissident that read "Free Tibet." Another pair of his sneakers implored China to "Free Uyghur" and yet another pair criticized Nike's manufacturing policies in China by stating "Made With Slave Labor," a December 7 *New York Post* article reported. Celtics games aren't being shown in China.

Even little Lithuania has stood up against China by allowing Taiwan last month to open a diplomatic office there, and Lithuania plans to open its own in Taiwan. China condemned the move as a violation of its "One China" policy and downgraded its diplomatic presence in Lithuania from ambassador to charge d'affaires. Last week, some of Lithuania's exports to China were blocked by a computer system; officials are investigating whether it was an isolated glitch or systemic retaliation. Access to the Chinese market was restored this week, a December 7 *SCMP* article reported.

These moves might have packed a larger punch if made by the NBA, LeBron James, and the US or UK instead of the WTA, Freedom, and Lithuania. But small moves today may presage bigger ones tomorrow.

Financial Services: Jumping into China Despite the Risks. In the Trump administration's 2020 trade deal, China agreed to accelerate the removal of foreign ownership limitations on Chinese investment banks and brokerages and to allow US firms greater access to China's financial markets—including those involved in banking, insurance, asset management, payments, and fund management.

The opening of China's financial markets comes as its economy is slowing. Q3 GDP growth was just 3.5%, down from 14.2% in Q3-2020 and 6.6% in Q3-2019 (*Fig. 3*). It also comes as President Xi Jinping has been flouting capital market rules and imposing his will on industries as diverse as gaming and tutoring and as large as Ant Financial and Didi. And the distress in China's real estate market discussed above is reflected in its ailing stock market: The China MSCI stock price index has fallen 20.3% ytd through Tuesday's close, making it the world's third-worst-performing stock market this year (*Fig. 4*).

Nonetheless, the Wizards of Wall Street are ignoring these red flags, perhaps at their peril, as they race to tap China's $40 trillion financial sector. Let's take a look at what they're up to:

(1) *Investment bankers taking ownership.* US banks and investment banks are rapidly increasing or taking full ownership of their joint ventures in China. As they do so, their executives have had to tread lightly on Chinese sensibilities and face criticism at home.

JPMorgan and Goldman Sachs have gained full ownership of their Chinese brokerages and are expanding their debt and equity underwriting business, trading, and cross-border merger and acquisition advisory work in China. Goldman has a relationship with ICBC Wealth Management, a local firm with 26 million personal customers and 730,000 corporate clients, a November 15 *NYT* article states. Bank of America plans to apply for permission to set up a brokerage in China, while Morgan Stanley has asked for approval to increase its ownership in its Chinese securities firm to 90% and its stake in a fund-management joint venture to 85%.

JPMorgan CEO Jamie Dimon found himself in hot water last month after noting that both JPMorgan and the Chinese Communist Party had been around for 100 years and betting that the former would outlast the latter. Chinese officials weren't amused. Dimon apologized.

(2) *Asset managers raising funds.* Asset managers are jumping into the pool too. BlackRock finished raising $1 billion in September from Chinese investors for the country's first mutual fund run by an asset manager that's wholly owned by a foreign firm. Fidelity International and Neuberger Berman have received approval to set up mutual fund arms in China, which Schroders and VanEck seek as well.

BlackRock launched its $1 billion fund for Chinese investors just weeks after it recommended that investors triple their allocation to Chinese assets. Those who took BlackRock's advice and invested in the Chinese MSCI index since that August 16 recommendation have lost 6.9% as of Tuesday's close and those who invested in the Hong Kong MSCI index have lost 9.4%, while investors in the US MSCI have gained 4.0%.

Additionally, BlackRock has come under criticism for advocating for ESG (environmental, social, and corporate governance) investing in the US yet not holding the Chinese companies in which it invests to the same standards.

Bridgewater Associates, a hedge fund, has had a license to raise funds in China since 2018 and last month raised the equivalent of $1.25 billion in its third investment fund. Bridgewater's founder Ray Dalio prompted a Twitter storm last week after he compared China to a "strict parent" when asked about the disappearance of dissidents. Senator Mitt Romney (R-UT) countered that Dalio's "feigned ignorance of China's horrific abuses and rationalization of complicity investments there is a sad moral lapse."

(3) *But what's at risk?* In a September 6 *WSJ* *editorial*, investor philanthropist George Soros laid out the risk the US faces as its financial services firms jump into the Chinese markets. He describes BlackRock and other asset managers as helping China and its repressive government win the "life and death conflict" the country is in with the US and democratic nations.

"The BlackRock initiative imperils the national security interests of the U.S. and other democracies because the money invested in China will help prop up President Xi's regime, which is repressive at home and aggressive abroad," Soros wrote. "Congress should pass legislation empowering the Securities and Exchange Commission to limit the flow of funds to China. The effort ought to enjoy bipartisan support."

If US firms help China establish a more sophisticated stock market, it could attract funds that otherwise might have been invested in US markets. The divisions have started to form. Last week, Didi Chuxing, a $39 billion ride-sharing company, announced that it plans to delist its US-traded shares just six months after listing in the US. At the same time, the SEC adopted rules that require Chinese companies with US-listed stocks to further open their books to US accounting firms, which may send the audit-averse among them packing. The money at stake is big—nearly 250 Chinese companies representing $2.1 trillion in shares trade on US exchanges, a December 2 *NYT* *article* reported.

Disruptive Technologies: Investing for the Spooks. In-Q-Tel (IQT) isn't exactly a household name; but with a *website*, it isn't top secret either. The not-for-profit firm invests in startup companies on behalf of the CIA and other government organizations, looking for technologies that the government's national security arms need now and in the future. The firm says it averages one investment per week, has more than 500 investments in its portfolio, and attracts $18 in private-sector funding for every $1 it invests.

IQT helps companies understand and access the government. The firm often invests in firms involved with digital intelligence, infrastructure, robots, intelligent connectivity, data analytics, AI and machine learning, and IT platforms. Winning investments include FireEye and Plantir.

IQT's Who's Who of a board is roughly split between venture capital giants and former military/intelligence brass. Investors include David McCormick of Bridgewater Associates; James Barksdale, former CEO of Netscape; Peter Barris of New Enterprise Associates; Howard Cox of Greylock; and Ted Schlein of Kleiner Perkins Caufield & Beyers. In the military camp are A.B. "Buzzy" Krongard and George Tenet, both former CIA chiefs; Jeffrey Smith, former CIA general council; Jami Miscik, former CIA deputy director for intelligence; and Admiral Mike Mullen, former chairman of the Joint Chiefs of Staff.

The US's technological competitive advantage is eroding, write IQT CEO Christopher Darby and EVP Sarah Sewall in the March/April *edition* of *Foreign Affairs*. The US needs to set technology R&D priorities and increase funding, particularly in areas that don't attract venture-capital dollars. China's share of global technology R&D spending has grown from under 5% in 2000 to over 23% in 2020, putting it on track to overtake US spending by 2025. Global leadership in technology is as powerful as military global leadership, they contend.

Some of IQT's recent investments include:

(1) IQT was one of a handful of investors that invested $25 million in Q-CTRL, a Sydney

based startup that "provides infrastructure software that improves quantum computing performance by addressing …hardware error and instability," a November 30 *TechCrunch* *article* explained. The company also develops quantum sensors and exploration technologies for the Earth, the moon, and Mars.

(2) IQT was part of a group that invested $26.4 million into Fleet Space Technologies, another Aussi startup, that has designed, built, and launched commercial nanosatellites, and plans ultimately to have a 140-satellite constellation. It aims to have satellite coverage of the planet to connect the millions of industrial devices that make up the Internet of Things, according to a November 16 *article* in *Space News*.

(3) GreyNoise Intelligence received a "seven-figure investment" from IQT last spring. GreyNoise has developed software that makes security operations more efficient by separating out important threats from the background noise. In addition to funding, IQT gives GreyNoise feedback on the software from its contacts in the intelligence community.

Calendars

US: **Thurs:** Jobless & Continuous Claims 228k/2.00m; WASDE Report; Natural Gas Storage. **Fri:** Headline & Core CPI 0.7%m/m/6.7%y/y & 0.5%m/m/4.9%y/y; Consumer Sentiment Total, Current Conditions, and Expectations 67.0/71.0/70.0; Federal Budget -$170.9b; Baker-Hughes Rig Count. (Bloomberg estimates)

Global: **Thurs:** Germany CPI -0.2%m/m/5.2%y/y; Germany Trade Balance €13.4b; China New Loans; China M2. **Fri:** Germany CPI -0.2%m/m/5.2%y/y; Italy Industrial Production 0.4%m/m/3.4%y/y; Spain Industrial Production 1.5%yy; UK GDP 22.2% y/y; UK Headline & Manufacturing Industrial Production 0.2%m/m/2.2%y/y & 0.1%m/m/1.4%y/y; UK Trade Balance -£14.1b;UK NIESR Monthly GDP Tracker. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment Indicators (***link***): The Bull/Bear Ratio (BBR) fell this week for the third week, to 1.57 (the weakest since late April 2020), after climbing the prior four weeks from 1.81 to 2.67. Bullish sentiment sank for the third week (by 17.4ppts), collapsing to

39.8% this week—the lowest since early April 2020—after climbing 16.8ppts (to 57.2% from 40.4%) the prior six weeks. Meanwhile, the correction count climbed for the fourth week to 34.9% after a five-week decline of 15.9ppts (to 21.2% from 37.1%); this week's percentage is approaching the 37.1% nine weeks ago, which was the highest since March 2020. Bearish sentiment rose this week for the third week, to 25.3%—the most bears since May 2020. The AAII Ratio slumped last week for the third week, to 38.6%, after climbing the prior two weeks from 57.5% to 66.7%—which was the highest since the end of June. Bullish sentiment fell last week for the third week, to 26.7%, after climbing from 39.8% to 48.0% the prior two weeks, while bearish sentiment rose for the third week, to 42.4%, after falling from 29.4% to 24.0% over the previous two-week period.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin remained steady last week at a new record high of 13.3%. Since the end of April, it has exceeded its prior record high of 12.4% in September 2018. It's now up 3.0ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues and earnings per share both rose w/w. They've both been making new record highs since the beginning of March and for the first time since February 2020. Since the Q2-2021 earnings season came in way better than expected, analysts have been playing catch-up with their lowball estimates from the Covid-19 shutdown period. Prior to this catch-up period, consensus S&P 500 forecasts had been falling at rates paralleling the declines during the 2008-09 financial crisis. Forward revenues growth fell 0.6ppt w/w to a 13-month low of 7.7%. That's down from a record high of 9.6% growth at the end of May and should continue to move lower as base effects subside. Still, that's up from 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth tumbled 2.0ppts to a 16-month low of 8.2% and should also continue to move lower due to base effects. That's down from its 23.9% reading at the end of April, which was its highest since June 2010, and up substantially from its record low of -5.6% at the end of April 2020. On a positive note, this year analysts have been raising their consensus forecasts for 2021 and 2022 revenues and earnings growth; the imputed profit margin estimate that we calculate from those forecasts has been rising too. They expect revenues to rise 16.0% in 2021 (unchanged w/w) and 7.2% (up 0.1ppt w/w) in 2022 compared to the 2.1% decline reported in 2020. They expect earnings gains of 49.9% in 2021 (up 0.1ppt w/w) and 8.2% in 2022 (unchanged w/w) compared to a 13.4% decline in 2020. Analysts expect the profit margin to rise 3.0ppts y/y in 2021 to 13.1% (unchanged w/w) from 10.1% in 2020 and to improve 0.1ppt y/y to 13.2% in 2022 (unchanged w/w). The S&P 500's weekly reading of its forward P/E fell 1.0pt to a five-week low of 20.5 from a five-month high of 21.5, but that's above its 17-month low of 20.4 in mid-October. That compares to 23.1 in early September 2020, which was the highest level since July 2000 and up from a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio fell 0.14pt w/w to a seven-week low of 2.72 from a record high of 2.86. That's still above its four-month low of 2.69 in mid-October and compares to its prior record high of 2.81 at the beginning of September and a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): Last week saw consensus forward revenues rise for all 11 S&P 500 sectors and forward earnings rise for nine sectors. Nearly all sectors are at or near record highs in their forward revenues, earnings, and profit margin. Energy still has forward revenues and earnings well below record highs, but its profit margin is the highest since August 2008. Financials, Real Estate, and Utilities have forward earnings at or near record highs, but their forward revenues and margins are lagging. Only three sectors posted a higher profit margin y/y in 2020: Consumer Staples, Tech, and Utilities. For 2021, a y/y improvement is expected for all but Utilities. Five sectors are expected to see margins decline or remain flat y/y in 2022: Communication Services, Financials, Health Care, Materials, and Real Estate. The forward profit margin was at record highs during 2018 for 8/11 sectors, all but Energy, Health Care, and Real Estate. Here's how they rank based on their current forward profit margin forecasts along with their record highs: Information Technology (25.0%, a record high this week), Communication Services (16.7, down from its 17.0 record high in early October), Real Estate (16.3, down from its 19.2 record high in mid-2016), Utilities (14.7, down from its 14.8 record high in early May), Materials (13.3, down from its 13.4 record high in mid-November), S&P 500 (13.3, record high this week), Health Care (11.2, back at a record high for the first time since April 2018), Industrials (10.4, down from its record high of 10.5% in mid-December), Consumer Staples (7.6, down from its 7.7 record high in early June), Consumer Discretionary (8.0, down from its 8.3 record high in mid-2018), and Energy (9.2 [13-year high], down from a record-high 11.2 in mid-2007).

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, 2020 after 14 weeks of Covid-19-related declines. Forward revenues and earnings have risen 21.7% and 57.5%, respectively, since then to new record highs. The forward profit margin has risen 3.2ppts to a record high of 13.3%, which exceeds its prior pre-Covid record of 12.4% in late 2018. During the latest week, all 11 sectors posted gains in either their forward revenues, earnings, or profit margin. Here's how the S&P 500 and its 11 sectors rank by their changes in forward revenues and forward earnings since May 28, 2020: Energy (forward revenues up 40.7%, forward earnings up 2,152.1%), Materials (32.8, 100.9), Information Technology (27.8, 47.3), Industrials (26.0, 77.8), Communication Services (24.5, 56.0), S&P 500 (21.7, 57.5), Financials (19.1, 65.9), Health Care (17.7, 31.3), Consumer Discretionary (16.9, 98.9), Real Estate (13.4, 30.3), Consumer Staples (13.3, 20.3), and Utilities (0.3, 6.1).

US Economic Indicators

JOLTS (*link*): Job openings resumed their rise in October after declining the prior two months, moving to within 65,000 of July's record high of 11.098 million. Job openings climbed 431,000 in October to 11.033 million after sliding 496,000 during the two months ending September to 10.602 million. There were 7.4 million unemployed in October, so there were 1.5 million available jobs for each unemployed person—the most on record going back two decades. Job openings increased in several industries in October, with the largest gains occurring in accommodation & food services (254,000), nondurable goods manufacturing (45,000), and educational service (42,000), while state & local government jobs ex education (-115,000) declined. Here's a look at the industries posting the biggest year-to-date increases in job openings: accommodations & food services (913,000), followed by health care & social assistance (636,000), manufacturing (530,000), professional & business services (341,000), transportation, warehousing & utilities (334,000), and retail trade (291,000). Turning to quits, this measure is generally voluntary separations initiated by the employee and therefore can be viewed as the workers' willingness and ability to leave jobs. The number of quits dipped 205,000 in October—remaining in record territory at 4.2 million—after increasing seven of the prior eight months, by 1.1 million, to a record-high 4.4 million, which exceeded its previous pre-Covid record high in July 2019 by 807,000. Before the pandemic, quits hovered around 3.5 million. Many employers are raising wages and incentives amid a severe labor shortage, which gives workers confidence that they can get better pay elsewhere.

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