MORNING BRIEFING
August 29, 2022

Troubled Times In The UK & China

Check out the accompanying chart collection.

Executive Summary: In the UK, fiscal and monetary policy are at odds. Massive tax cuts and new spending programs will boost government debt—aggravating inflation even as the BOE is trying to subdue it. Bond Vigilantes clearly disapprove. … In China, the real estate sector is in shambles, and the government's investments abroad are going belly up. A messy debt restructuring looks likely. The PBOC is hustling to prop up both the falling yuan and the weakening economy, introducing new rules to discourage shorting the currency and easing monetary policy at a time when other central banks are tightening.

UK: Pounded. The UK is spending a lot of money that it doesn't have, and Bond Vigilantes—already on alert due to high inflation—aren't going to stand for it. In early September, new Prime Minister Liz Truss announced a plan to spend billions to subsidize citizens' energy bills. Then last week, the UK Chancellor Kwasi Kwarteng proposed a plan to boost the economy by cutting taxes and borrowing heaps of debt. This flies in the face of the Bank of England's (BOE) efforts to tame inflation, which has soared due to painfully high energy prices.

The mixed messages resulted in a sharp bond market selloff that forced the BOE to react on Wednesday. It's a tough way to start a new administration. Let's take a look:

(1) *The tax-cut plan.* UK Chancellor Kwarteng laid out a plan to boost economic growth by cutting taxes and borrowing £45 billion, which equals 1.5% of GDP, by 2026-27. The move could push the UK's public borrowing to more than £190 billion, the third highest since the second World War. And it's occurring as interest rates have jumped, making the borrowing more expensive.

Under the proposal, taxes on the highest earners will drop to 40% from 45%, and the cap on bankers' bonuses will be removed. Homebuyers will start paying a tax when purchasing a £250,000 home, up from a £125,000 home. And 40 new investment zones will be created in which businesses will pay low taxes.

(2) *The energy-cap plan.* Earlier this month, Prime Minister Truss unveiled her £150 billion package to limit consumers' and businesses' exposure to the jump in energy prices. The average annual household energy bill will be limited to £2,500 over the next two years, a September 8 *FT* article explained. In addition, an energy bill discount will be retained and green levies eliminated, which will reduce annual bills to roughly £1,950 (the actual amount households pay will fluctuate based on usage). Without these measures, the average household bills were expected to rise to £3,500 in October and climb as high as £6,000 next year.

Businesses and public institutions will also receive support under Truss's plan but only for six months. After that period, support will go to vulnerable industries, which will be identified in the future.

Truss also announced a £40 billion liquidity facility to help energy companies handle the market's volatility and avoid a potential cash flow crisis. Electricity generators have to post much more collateral to hedge future production. Truss also plans to encourage fracking and provide more licenses for oil and gas projects in the North Sea.

(3) *The market's reaction.* Investors have given the new fiscal plan a swift thumbs down. Investors fear that the large spending package will exacerbate already high inflation levels. The UK CPI was at 9.8% in August, while the core CPI had climbed to 6.2% (*Fig. 1*).

At its lowest point on Wednesday, the pound relative to the dollar fell 3% from Thursday's close (before the UK chancellor's plan was announced) and 21% from this year's high in early January to 1.090 (*Fig. 2*). The yield on the 10-year government bond jumped to a high of 4.48% on Tuesday, up from 3.50% on Thursday and its low of 0.97% this year (*Fig. 3*). And the UK MSCI stock price index fell 3.1% ytd through Wednesday's close (*Fig. 4*).

The jump in interest rates was so dramatic that some British banks have stopped offering new home mortgage loans or have reduced the loans they offered, opting to wait until the market settles down before returning to the market.

(4) *The pivot.* The BOE responded to the market turmoil by pivoting on Wednesday. The central bank suspended its quantitative tightening plan and announced plans to buy long-term bonds instead. The BOE's quantitative tightening plan, which was slated to start next week, involved selling almost $900 billion of government bond holdings to reduce UK inflation. Post-pivot, the BOE plans to buy long-term bonds through mid-October. The central bank said that it would make purchases at "whatever scale is necessary" and that the UK Treasury would fund any losses.

The International Monetary Fund frowned on the UK's fiscal plans, saying that large, untargeted fiscal packages are not recommended during times of high inflation. Likewise, Moody's said the tax cuts were a credit negative and likely to hurt economic growth.

UK 30-year bond yields, which were just south of 5% prior to the announcement, fell to 3.93% on Wednesday, their biggest drop on record, according to a *FT* article yesterday. The pound, however, continued its decline, trading around 1.090 against the dollar. Now the questions are whether the BOE will need to raise interest rates to defend the pound and by how much. Already this year, the central bank has raised its base rate to 2.25% from 0.10% (*Fig. 5*).

China: The Great Restructuring. China has a debt problem. Domestically, indebted real estate companies have built ghost towns of empty residential towers, leaving their buyers trapped by the mortgage debt they've incurred to pay for these unfinished units. Internationally, the Chinese government has lent money to projects in emerging market

countries that are going belly up, their forecasted cash flows having failed to materialize. Restructuring China's debt is bound to be slow and painful, as nearly all debt restructurings are.

China's real estate sector is dragging down the country's economic growth, as are the country's restrictive Covid policies. Chinese industrial profits have fallen 2.1% y/y during the first eight months of 2022, and the World Bank lowered its forecast for China's economic growth in 2022 earlier this week to 2.8% from 4.3% back in June.

China's deteriorating economic picture has its central bankers cutting interest rates when their counterparts the world over are raising interest rates, and that's putting pressure on the yuan. Let's look at some of the recent news contributing to the situation:

(1) *Debt at home.* China's leveraged real estate sector continues to restructure billions of dollars of debt and look for new sources of capital to finish half-built buildings. Sunac China, which has defaulted on its dollar bonds, is seeking to extend by six months its repayment on almost $560 million of domestic debt. It would be the third extension of the debt's maturity date, Reuters *reported* this week.

Meanwhile, China Evergrande Group, which has more than $300 billion of debt, announced that Shenzhen Longgang Ancheng Investment Operation would be brought in to help with project construction at four developments in Shenzhen, a September 27 Reuters *article* reported.

There are new funds being raised to invest in distressed properties. China Construction Bank is setting up a $6 billion fund to buy properties from developers to turn them into rental properties. Meanwhile, it was reported this summer that China was raising a $44 billion real estate fund to support the sector. But so far, there's no indication that the worst has passed. Average new home prices in 70 Chinese cities fell 2.1% m/m in August, which follows a 1.7% m/m price decline in July.

(2) *Debt abroad.* "Debt-trap diplomacy" is what detractors call China's Belt and Road policy. The country spent roughly $1 trillion on projects in 150 countries scattered throughout Asia, Africa, and Latin America. Many of the projects were extremely leveraged. For every $1 of aid China provided, it lent out $9 of debt, while similar US-subsidized projects were funded with $9 of aid for every $1 of debt, a September 26 *WSJ* article reported. Now China has to determine what to do with projects that aren't throwing off enough cash to service the debt.

In many cases the solution will involve extending maturities, reducing interest payments, forgiving debt or some combination of the above. Chinese creditors Export Import Bank of China and the China International Development Cooperation Agency have suspended more than $1.3 billion in debt service in 23 countries under the G20 program, including 16 African nations, according to Johns Hopkins School of Advanced International Studies research quoted in a September 27 *South China Morning Post* article. These Chinese creditors suspended debt service in Kenya ($378 million), Zambia ($110 million), Tajikistan ($40 million), and Maldives ($25 million).

Earlier this month, China restructured $3.2 billion of private debt owed by Ecuador. The China Development Bank extended the maturities on $1.4 billion of debt to 2027, and the

Export-Import Bank of China pushed out the maturities on $1.8 billion of loans to 2032. Amortization payments on those loans were reduced, and the total relief granted to Ecuador was pegged at $1.4 billion, according to a September 19 Reuters *article*.

Zambia is negotiating the restructuring of $17 billion of external debt, $6 billion of which is owed to Chinese lenders. Chinese lenders are also the largest creditors to Sri Lanka, which defaulted on $47 billion of external debt last year. Laos appears likely to require debt restructuring soon; about half of its $14.5 billion of foreign debt is owed to China. And Pakistan owes $30 billion, or about 30% of its foreign debt, to China.

China hasn't joined the Paris Club, a group of 22 nations that helps nations pay off loans, as membership requires greater transparency than China is willing to provide. China tends to favor extending maturity dates on debt over forgiving debt, as typically occurs in Paris Club restructurings. However, a September 26 *WSJ* *article* reported that Chinese policymakers are hashing out a more conservative lending program, internally dubbed "Belt and Road 2.0," and that they're increasingly open to renegotiating debt even if that means accepting losses, "something they had been previously unwilling to do."

(3) *Covid cases continue.* Covid-19 cases continue to pop up in China. On Sunday, China reported 999 new Covid cases, on par with the 936 new cases reported on Saturday. Citizens are getting tired of the government's zero-Covid policy lockdowns, which have been a drag on economic growth.

A "snap" lockdown of Shenzhen after 10 new Covid cases were reported prompted dozens of people to protest, chanting "lift the Covid lockdown." Citizens may use public transportation and enter restaurants and hospitals only if they've tested negative on a PCR Covid test within the past 24 hours, a September 27 *article* in *Channel News Asia* reported.

Conversely, Hong Kong has lifted some of its Covid-19 controls, including the requirement that incoming travelers quarantine in a hotel upon arrival; they still must take Covid tests for a week and abstain from visiting restaurants and bars for three days. Likewise, Macau plans to ease Covid restrictions, making it easier for citizens to travel to the city, in November.

(4) *Yuan falling fast.* The yuan has fallen 12% against the dollar since peaking at the end of February (*Fig. 6*). The currency, which hit a 14-year low on Wednesday, has come under pressure as the Federal Reserve has increased US interest rates, strengthening the dollar, while the People's Bank of China (PBOC) has cut interest rates and bank reserve requirements, most recently in August (*Fig. 7*).

The PBOC has tried to stem the decline of the yuan by introducing policies that increase the cost of shorting the currency. Specifically, the central bank has "[lowered] the amount of foreign exchange financial institutions must hold as reserves and reinstated risk-reserve requirements on currencies purchased through forwards," September 27 Reuters *article* reported.

The China MSCI share price index has maintained a downward path this year. It has fallen 28.3% ytd and 53.6% from its February 17, 2021 record high (*Fig. 8*). Revenues for companies in the China MSCI index are expected to rise 10.9% this year and 7.2% in 2023 (*Fig. 9*). Earnings are also expected to climb, by 9.5% this year and 15.5% in 2023, though

net earnings revisions have been decidedly negative over the past year (*Fig. 10* and *Fig. 11*).

Calendars

US: Thurs: Jobless & Continuous Claims 215k/1.388m; Real GDP -0.6%; GDP Price Index & Core PCED 8.9%/4.4%; Corporate Profits; Natural Gas Storage; Bullard; Mester. **Fri:** Personal Income & Spending 0.3%/0.2%; Core PCED 0.5%m/m/4.7%y/y; Consumer Sentiment Index 59.5; Chicago PMI 51.8; Baker-Hughes Rig Count; Williams; Brainard; Mester; Bowman. (Bloomberg estimates)

Global: Thurs: Eurozone Business & Consumer Confidence 95.0; Germany CPI 1.3%m/m/9.4%y/y; Spain CPI 10.1%; Canada GDP -0.1%; Japan Unemployment Rate 2.5%; Japan Jobs/Applications Ratio 1.30; Japan Industrial Production; Japan Retail Sales 2.8%; China Caixin & S&P Global M-PMIs 50.2/49.2; Panetta; De Guindos; McCaul; Elderson; Ramsden. **Fri:** Eurozone CPI Flash Estimate 9.7%; Eurozone Unemployment Rate 6.6%; Germany Retail Sales -1.0%m/m/-5.1%y/y; Germany Import Prices 2.0%m/m/29.9%y/y; Germany Unemployment Change & Unemployment Rate 20k/5.5%; France Consumer Spending -0.1%; France CPI; Italy Unemployment Rate 7.9%; Italy CPI 0.1%m/m/8.7%y/y; UK GDP Japan Consumer Confidence; Japan Housing Starts -4.1%; Elderson; Buch; Schnabel. (Bloomberg estimates)

Strategy Indicators

Stock Market Sentiment (*link*): The BBR sank further below 1.00 this week, dropping for the second week to 0.74 (the lowest since the June 21 week's 0.60), after rising from 1.00 to 1.15 the prior week. Bullish sentiment fell for the second week to 25.4% (the fewest bulls since early 2016) after rising from 29.7% to 32.4% the previous week; it was at 45.1% five weeks ago. Meanwhile, bearish sentiment moved up from 28.2% to 34.3% over the two-week period, exceeding bullish sentiment again this week, to its highest percentage since the July 19 week. The correction count remained the largest group again this week, climbing to 40.3%, after dropping from 40.6% to 38.6% the prior two weeks. In the meantime, the AAII Sentiment Survey (as of September 22) showed investors describing their six-month outlook for stocks as bearish, jumping to its highest level since 2009, while the bullish sentiment percentage ranks among the 20 lowest in survey history. The percentage expecting stocks will rise over the next six months sank 8.4ppts (to 17.7% from 26.1%) during the latest week, with optimism remaining below its historical average of 38.0% for the 44th consecutive week, and was unusually low for the fourth successive week and the 27th time in 38 weeks. The percentage expecting stocks to fall over the next six months rose for the fifth time in six weeks, by 24.2ppts (60.9 from 36.7), with 14.9pps occurring during the latest week. Bearish sentiment has been above its historical average of 30.5% in 43 of the last 44 weeks, and is at an unusually high level for the 28th time in 36 weeks. (The breakpoint between typical and unusually high readings is currently 40.5%.)

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin dropped 0.1ppt last week to a 14-month low of 13.0%. That's down 0.4ppts from its record high of 13.4% achieved intermittently from March to June. Since the end of April

2020, it has exceeded its prior record high of 12.4% in September 2018. It's now up 2.7ppts from 10.3% during April 2020, which was the lowest level since August 2013. Forward revenues rose back up to a fresh record high, but forward earnings dropped 0.6% w/w to 1.7% below its record high in mid-June. Both had been steadily making new highs from the beginning of March 2021 to mid-June; prior to that, they peaked just before Covid-19 in February 2020. The consensus expectations for forward growth remained steady w/w as analysts await the start of the Q3 earnings season. Forward revenues growth was steady at a 23-month low of 5.7%, down from a record high of 9.6% growth at the end of May 2021. Still, that's up from 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. Forward earnings growth was unchanged w/w at a 24-month low of 7.3%. That's down from its 23.9% reading at the end of April 2021, which was its highest since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. So far this year, analysts' revisions to their forecasts for 2022 revenues have outpaced their revisions for 2022 earnings, so the imputed 2022 profit margin estimate that we calculate from those forecasts has ticked down 0.5ppt to 12.7%. They expect revenues to rise 11.9% (down 0.1ppt w/w) in 2022 and 4.2% in 2023 (up 0.1 ppt w/w) compared to the 16.3% gain reported in 2021. They expect earnings gains of 9.3% in 2022 (down 0.3ppt w/w) and 7.3% in 2023 (down 0.2ppt w/w) compared to an earnings gain of 50.4% in 2021. Analysts expect the profit margin to drop 0.3ppt y/y to 12.7% in 2022 (down 0.1ppt w/w) compared to 13.0% in 2021 and to improve 0.4ppt y/y to 13.1% in 2023 (unchanged w/w). The S&P 500's weekly reading of its forward P/E fell 0.6pt w/w to a nine-week low of 16.2. That compares to a 15-week high of 18.2 in mid-August and is up from a 26-month low of 15.8 in late June. That also 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 dropped 0.09pt w/w to a 28-month low of 2.10. That's down from a 15-week high of 2.38 in mid-August. That also compares to a record high of 2.88 at the end of 2021 and a 49-month low of 1.65 in March 2020.

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US Economic Indicators

Pending Home Sales (*link*): "The direction of mortgage rates—upward or downward—is the prime move for home buying, and decade-high rates have deeply cut into contract signings," said Lawrence Yun, NAR's chief economist. "If mortgage rates moderate and the economy continues adding jobs, then home buying should also stabilize." The Pending Home Sales Index (which tracks sales when a contract is signed but the transaction has not yet closed) fell for the third successive month and the ninth time in 10 months, by 2.0% in August and 27.8% over the period, to 88.4—the lowest since April 2020. Regionally, pending home sales rose in only one region again for the second straight month—the West—while all four regions showed double-digit declines versus a year ago, with the West showing the largest yearly drop. Here's the tally on a monthly and yearly basis: West (+1.4% m/m & -31.3% y/y), South (-0.9 & -24.2), Northeast (-3.4 & -19.0), and Midwest (-5.2 & -21.1). Yun expects the economy to remain sluggish through the rest of the year, with mortgage rates climbing close to 7.0%. "Only when inflation calms down will we see mortgage rates begin to steady," noted Yun. The NAR expects existing home sales to drop 15.2% this year to 5.19mu, while new home sales are forecast to fall by 20.9%.

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