MORNING BRIEFING
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Hard Landing In China, No Landing In US

Check out the accompanying chart collection.

Executive Summary: China's economic pain has been the US's economic gain, as it has lowered the prices Americans pay for goods from China, pulling US inflation lower. Today, we examine how China got into its economic morass and what policymakers there hope to do about it. … Also: With the US economy flying high and US retail sales in July up from June levels, might American consumers return China's favor? It may be too soon to bet on a resumption of US consumers' halted goods buying binge. … And: Joe pulls back the curtain on S&P 500 sector reclassification changes for an apples-to-apples look at technology companies' changing market-cap representation in the index.

China's Economy I: Desperately Seeking a New Engine. The Chinese are providing American consumers with cheaper goods. By doing so, the Chinese are increasing the purchasing power of American consumers, who are doing what they do best; they are shopping. It's a gain for the US economy, which is getting better economic growth with lower inflation. It's a loss for Chinese consumers, who are facing deflation and higher unemployment and dealing with the consequences of the bursting of their property bubble. China's rapidly aging demographic profile is only exacerbating these problems.

The woes in the Chinese property market are weighing on consumer spending since many of the Chinese have significant portions of their personal assets in brand new empty apartments. They were worth owning when they appreciated in value, but now they have been losing value. The persistent drag in the property sector is impeding the sale of land by local governments, which is depressing their revenues and their spending on infrastructure as well as making it harder to service their debts.

Additionally, foreign demand for Chinese goods continues to be weak, posing a major impediment to fostering a sustainable economic recovery. Youth unemployment is at a record high. China is attempting a painful transition to a less debt-fueled, less property-centric, and less export-oriented economy. The problem is that it isn't turning into a consumer-driven economy as government officials had hoped.

The Chinese government desperately has been seeking a new engine for growth without any success so far.

China's Economy II: Lots of Woes. Jackie and I have been on top of this story for quite a while. In tomorrow's *Morning Briefing*, she will provide an update of the mess in the property market. Today, let's review the latest developments in this ongoing saga:

(1) *Consumer spending and the CPI.* Retail sales rose 2.5% y/y, down from a 3.1% increase in June, and missed analysts' forecasts of 4.4% growth (*Fig. 1*). Real retail sales rose 2.8% as the CPI declined 0.3% y/y in July, falling for the first time in two years and sparking fears of deflation (*Fig. 2*). The underlying growth rate of real retail sales has plunged from more than 15% during the late 2000s to the low single digits now, reflecting the rapidly aging demographic profile of Chinese consumers (*Fig. 3*). China continues to be the world's largest nursing home.

(2) *Trade.* Last week, the National Bureau of Statistics reported greater-than-expected declines in July exports and imports (*Fig. 4*). The former was down 9.3% y/y, while the latter was down 6.7% y/y. Imports has been virtually flat since mid-2021.

(3) *Industrial production & the PPI.* Industrial production rose 3.7% y/y in July, down from 4.4% in June and missing the consensus forecast of 4.6% (*Fig. 5*). It has been sliding downward along with real GDP growth since 2010. Chinese factories have been challenged by weak demand at home and less demand for exports overseas, as western consumers have been pulling back on spending and foreign producers have been moving their factories to friendlier countries in response to China's increasingly anti-business regulations and hostile foreign policy.

Foreign direct investment in China in Q2-2023 was just $4.9 billion, according to data from China's balance of payments, the lowest quarterly total in records starting in 1998.

(4) *Unemployment*. The urban unemployment rate rose in July, for the first time since February, to 5.3% from 5.2% in June. More troubling is that the urban unemployment rate for people aged 16 to 24 has ratcheted up steadily from month to month this year, hitting a record 21.3% in June—four times the overall jobless figure. Chinese officials announced on Tuesday that they will temporarily stop publishing the youth unemployment rate, claiming they need to refine how it's calculated.

China's universities churn out lots of graduates with skills that don't match the needs of employers. Job opportunities have been reduced in several heavily regulated industries, including education, real estate, and technology.

(5) *Property*. Country Garden Holdings, one of China's largest real-estate developers, missed payments on some of its bonds and warned that it expects to post a record loss for the first six months of the year as sales and profit slump. The property bubble is still bursting.

(6) *Credit.* Data released on Friday showed that Chinese banks lent far less than expected to households and businesses last month, highlighting weak demand for borrowing despite a succession of interest-rate cuts by the People's Bank of China (PBOC). Chinese bank loans rose by just $5.1 billion during July, down sharply from June's gain of $453.4 billion and the lowest since October 2006 (*Fig. 6*).

Household loans, mostly mortgages, fell by 200.7 billion yuan in July, after rising 963.9 billion yuan in June as the debt crisis in the property sector worsened, while corporate loans slid to 237.8 billion yuan last month from 2.28 trillion yuan in June.

(7) *Policy.* Earlier Tuesday, the Chinese central bank unexpectedly cut its key interest rate for the second time in three months to boost the economy. The August 15 *WSJ* *reported*: "The People's Bank of China said Tuesday that it lowered the interest rate on a key facility that funnels one-year loans to banks to 2.5% from 2.65% previously, at the same time shoveling the equivalent of $55.2 billion of new loans into the banking system. Such a move is usually followed within days by a reduction in bank lending rates to households and businesses."

US Economy I: China's Gift to the US. The question is: Will American consumers save China from a bad recession? One of the reasons for China's woes stems from the behavior of American consumers, after all: They embarked on a goods buying binge when the pandemic lockdowns were lifted in the spring of 2020. But that binge ended unexpectedly around year-end 2021 when US consumers pivoted to purchasing services as social distancing restrictions were lifted. Chinese exporters benefited greatly from the goods buying binge in the US. But they've been forced to lower their export prices to maintain their sales to Americans so far this year.

The US import price index fell 4.4% y/y and 1.3% y/y with and without petroleum (*Fig. 7*). Contributing to the decline was the US import price index from China, which was down 2.3% y/y through July (*Fig. 8*). China's homegrown deflation in its PPI, which was down 4.4% y/y, is likely to continue to weigh on the US import price index from China (*Fig. 9*).

China's recession and deflation are reducing the risks that the US must fall into a recession to bring down inflation!

US Economy II: Consumers Buying More Goods Again. In the US, the rolling recession that hit the goods market since mid-2021 seems to be morphing into a rolling recovery, as we've been predicting. Retail sales jumped 0.7% m/m during July. That same month, the headline CPI for goods fell 0.1% m/m. As a result, the Atlanta Fed's *GDPNow* tracking model increased its latest forecast for Q3's real GDP from 4.1% to 5.0%, led by an increase in real consumer spending from 3.2% to 4.4%.

Not only has there been no hard landing, but also the soft-landing scenario may be history. Until further notice, it's looking more like a no-landing scenario, consistent with our rolling recovery thesis. However, the housing industry is likely to roll back into its recession given the recent jump in mortgage rates. The National Association of Home Builders (NAHB) Housing Market Index (HMI) fell 6 points from last month to 50, the index's first monthly decline in the past eight months. The commercial real estate market is certainly rolling into a recession, especially now that long-term interest rates have moved higher.

Before we get too excited about July's retail sales report, let's keep in mind the following:

(1) Housing-related retail sales remain weak (*Fig. 10*). Building materials are included in the residential investment component of GDP.

(2) Sales at nonstore retailers jumped 1.9% m/m during July because of Amazon's Prime Day sale during the month (*Fig. 11*).

(3) Food services and drinking places reported a 1.4% collective increase in their sales during July (*Fig. 12*). In the GDP calculation, this industry is included in consumer services rather than consumer goods.

(4) On an inflation-adjusted basis, retail sales remains on its flat trend that started in mid-2021. It is still on a modest downward trend over this period excluding building materials and food services (*Fig. 13* and *Fig. 14*).

Strategy: Tech's Market-Cap Share. Since the introduction of the PC in the early 1980s, businesses have used and integrated computing technology into their operations to improve productivity and profitability. Back then, the first question of portfolio managers looking at investment candidates was: "What's the dividend yield?" Now that question is: "Is it a tech company?" Then come questions about how the company leverages technology to business advantage—and looming in the back of minds: “Could this company become another Amazon?”

We strive to provide the data showing how much tech stocks influence the broader stock market’s performance. But now that new tech is being created and used everywhere, tracking how great a part of the stock market technology companies represent is no longer a simple exercise.

Using data since 1985, we have tracked each S&P 500 sector’s market-capitalization share of the S&P 500 index. For much of that time since, their capitalization shares have changed as portfolio managers invested funds based on the fundamental fortunes of the companies within each sector. However, there have been tracking complications along the way. Their capitalization share has also changed as constituents were added and removed from the index. This was especially true for the Information Technology sector, which saw many companies reclassified out of the sector in 2018 and again this year in March.

(1) *Impact of past reclassifications on Tech’s market-cap share.* Following the market’s close on September 21, 2018, Information Technology’s total market capitalization dropped 20.5% overnight as companies were reclassified to the newly renamed Communication Services and Consumer Discretionary sectors. Among them were several of today’s largest companies, Alphabet and Meta. As a result, Tech saw its market-cap share drop in September 2018 to 20.6% from 25.9%. Earlier this year, on March 17, S&P/MSCI removed the Data Processing & Outsourced Services sub-industry from the Information Technology sector and transferred the bulk of the companies to a new sub-industry in the Financials sector called “Transaction Processing & Payment Services.” The resulting 10.7% decline in Tech’s market capitalization caused the sector’s market-cap share to drop overnight to 25.9% from 29.0%.

(2) *Tech’s current share looks peaky.* During the August 3 week, Tech’s share of the S&P 500’s market cap was 27.9% (*Fig. 15*). Despite the GICS reductions in 2018 and 2023, that’s still the highest market-cap share of the S&P 500’s 11 economic sectors. But it isn’t even close to the record-high 34.2% during the June 23, 2000 week. Or is it? Had the reclassifications never happened, Joe’s analysis found, Tech’s market-cap share would be very different.

(3) *Undoing reclassifications boosts Tech’s share to new record.* Joe redid Information Technology’s current market capitalization to include the companies that were removed from the sector in 2018 and 2023 (*Fig. 16*). This adjustment of Tech’s market capitalization

boosts the sector's market-cap share to 35.3% as of the August 11 week, well above the 27.1% at which it stands with the reclassification.

Comparing Tech's total market cap on an apples-to-apples basis with its historical record, that 35.3% share surpasses Tech's prior record of 34.2% during the June 23, 2000 week. Tech's adjusted market-cap share peaked during the July 14 week at a record-high 36.6%.

Calendars

US: Wed: Housing Starts & Building Permits 1.44mu/1.46mu; MBA Mortgage Applications; Headline & Manufacturing Industrial Production 0.3%& -0.1%; Crude Oil Inventories & Gasoline Production; FOMC Meeting Minutes. **Thurs:** Leading Indicators -0.4%; Philadelphia Fed Manufacturing Index -10.0; Initial & Continuous Jobless Claims 240k/1.692m. (Bloomberg estimates)

Global: Wed: Eurozone GDP 0.3%q/q/0.6%y/y; Eurozone Industrial Production -0.6%m/m/-4.2%y/y; Eurozone Employment Change 0.3%q/q/1.6%y/y; Spain Consumer Confidence 85.7; UK Headline & Core CPI -0.5%m/m/6.8%y/y & 0.3%m/m/7.4%y/y; UK PPI Input & Output -0.7%m/m/-51.%y/y & -0.4%m/m/1.2%y/y; Japan Core Machinery Orders -5.5%; Australia Employment Change 21.5k; Australia Unemployment & Participation Rates 3.5%/66.8%. **Thurs:** Eurozone Trade Balance €18.3b; UK Gfk Consumer Confidence; Japan Tertiary Activity Index -0.2%; Balz. (Bloomberg estimates)

Strategy Indicators

S&P 500 Q2 Earnings Season Monitor (*link*): With the Q2-2023 earnings season now nearly 91% complete and the July quarter-end companies just beginning to report, the indications from the companies that have reported so far suggest a slightly stronger earnings surprise than in Q1-2023 but a weaker revenues surprise. During Q4-2022, the earnings surprise was the lowest since Q4-2008 and the revenue surprise the smallest since Q1-2020. Furthermore, the earnings surprise failed to outpace the revenue surprise in Q4-2022 for the first time since we began tracking that data in Q1-2009. With 458 of the S&P 500 companies finished reporting for Q2-2023, revenues are ahead of the consensus forecast by 1.8%, and earnings have exceeded estimates by 7.7%. At the same point during the Q1 season, revenues were 2.3% above forecast, and earnings had beaten estimates by

7.1%. For the 458 companies that have reported Q2 results so far through mid-day Tuesday, only 63% has reported a positive revenues surprise; if the companies yet to report don't raise that number, Q2 would have the narrowest revenues beats reading since Q1-2020. But 78% have reported a positive earnings surprise, well above the pace of the prior six quarters dating back to Q4-2021. The reporting companies' aggregate y/y revenues and earnings growth rates are mixed from their Q1-2023 readings: tumbling to -7.6% from -3.5% for earnings growth and dropping to 0.8% from 4.0% for revenues growth. Over the past 57 quarters through Q1-2023, y/y earnings growth has trailed y/y revenues growth in only 15 quarters including the past five, and it's already doing so again in Q2-2023 as Energy sector results are being reported. Excluding the Energy sector's results from the S&P 500 companies that have already reported underscores Energy companies' outsized drag on the S&P 500's y/y growth rates: earnings growth improves to -1.3% from -7.6%, and revenue growth rises to 4.4% from 0.8%. Significantly fewer companies have been reporting positive y/y earnings growth in Q2 (55%) than positive y/y revenues growth (66%). These figures will change slightly as the remaining Q2-2023 results are reported in the coming weeks, but the overall tune has been set. We expect the overall y/y revenues growth rate to remain positive in Q2, but earnings are sure to post their biggest y/y decline for the S&P 500 since Q2-2020 due to the downturn in results from companies in the Energy and Materials sectors.

US Economic Indicators

Retail Sales (*link*): Retail sales in July were a surprise on the upside, and there was a slight upward revision to June sales. *Total retail sales* jumped 0.7% (vs 0.4% expected) in July, following a revised 0.3% (from 0.2%) gain in June. Sales have increased the past four months, by a total of 2.2%, after contracting 1.6% during the two months through March, for a ytd gain of 3.4% to a new record high. Meanwhile, sales in the *control group*—which excludes autos, gasoline, building materials, and food services—has recorded only one decline this year, climbing 1.0% in July and 3.7% ytd to a new record high. This measure correlates closely with the consumer spending component in GDP. Of the *13 nominal retail sales categories*, nine rose in July while four fell. Here's a snapshot of the 13 categories' *July sales performance versus that of a year ago*: nonstore retailers (1.9% m/m & 10.3% y/y), sporting goods & hobby stores (1.5 & 1.0), food services & drinking places (1.4 & 11.9), clothing & accessories stores (1.0 & 2.2), general merchandise stores (0.8 & 2.5), food & beverage stores (0.8 & 2.5), health & personal care stores (0.7 & 8.1), building materials & garden equipment (0.7 & -3.3), gasoline stations (0.4 & -20.8). miscellaneous store retailers (-0.3 & 2.4), motor vehicles & parts (-0.3 & 7.6), electronics & appliance stores (-1.3 & -3.1), and furniture & home furnishings (-1.8 & -6.3).

Business Sales & Inventories (*link*): Both nominal and real business sales remain in record territory, though are down from their recent record highs. *Nominal business sales* fell for the fourth time in five months in June, by 0.1% m/m and 1.8% over the period. Since reaching a record high last June, sales have decreased seven months, increased four months, and were unchanged one month—falling 3.1% y/y. Meanwhile, *real business sales* in May rebounded 1.1% after a three-month slide of 1.7%. These sales reached a record high in January 2022 and currently are only 0.8% below that record level. In the meantime, the real inventories-to-sales ratio in May ticked down to 1.48 from 1.49—which was the highest since mid-2020, though up from a recent low of 1.37 in fall 2021. Meanwhile, the nominal ratio in June was unchanged again at March's 1.40—which was the highest since the mid-2020s.

Regional M-PMIs (*link*): The New York Fed has provided the first glimpse of manufacturing activity for August, and it showed a sharp contraction as both new orders and shipments plummeted. August's *composite index* deteriorated for the second month, by 20.1 points this month and 25.6 points over the period to -19.0—following wide monthly swings the first six months of this year, from January through June of -21.7, +27.1, -18.8, +35.4, -42.6, and +38.4. The new orders (to -19.9 from 3.3) and shipments (-12.3 from 13.4) components plunged this month. Meanwhile, *delivery times* (1.9 from -6.9) held steady in August, and inventories (-9.7 from -10.8) continued to move lower. Labor market indicators pointed to relatively steady *employment* (-1.4 from 4.7) levels but a shorter *average workweek* (-10.7 from 0.2). Turning to *prices,* both the prices-paid (25.2 from 16.7) and prices-received (12.6 from 3.9) measures picked up a bit this month, after posting their lowest reading since summer 2020 in July. Both price measures are down sharply from their record highs of 86.4 and 56.1, respectively, during April and March of last year. Looking ahead, *the index of future business conditions* remains on an upward trend, in expansionary territory, climbing to a 17-month high of 19.9 this month; its recent bottom was -6.1 in November. Both new orders (28.1 from 11.0) and shipments (29.6 from 12.0) are expected to increase significantly, and employment (24.9 from 13.2) is expected to pick up.

NAHB Housing Market Index (*link*): "Rising mortgage rates and high construction costs stemming from a dearth of construction workers, a lack of buildable lots and ongoing shortages of distribution transformers put a chill on builder sentiment in August," noted NAHB Chairman Alicia Huey. "But while this latest confidence reading is a reminder that housing affordability is an ongoing challenge, demand for new construction continues to be supported by a lack of resale inventory, as many home owners elect to stay put because they are locked in at a low mortgage rate," she added. *Homebuilders' confidence* posted its first decline this year in August, slumping to 6 points to 50, after a jumping 25 points the first seven month of this year 56. Confidence fell all 12 months of 2022, by 53 points, to 31—which was the lowest since the height of the pandemic. Of the *three components of homebuilders' confidence*, two climbed steadily over the first seven months of this year, *current sales* (+26 points to 62) and *traffic* (+20 to 40), though they fell to 57 and 34 respectively though July. *Future sales* dropped for the second month, to 55 from June's 13-month high of 62.

Import Prices (*link*): Import prices rose in July for only the second time this year, led by higher costs for fuel and food; underlying inflation pressures remaining subdued. *Import* prices rose 0.4% in July, after falling in five of the prior six months by 1.6%. Prices fell 4.4% y/y, down from its recent peak of 13.0% in March 2022. *Nonpetroleum* prices were flat in July after a five-month slide of 1.5%; the yearly rate is -1.3%, slowing from last March's recent peak of 8.1%. Fuel prices posted the third gain in the past four months during July, rising 4.4% over the period after a nine-month slide of 37.1%. The yearly rate fell to a 36-month low of -36.8% in June, narrowing to -28.7% in July; it peaked at 130.1% in April 2021. Meanwhile, here's the yearly rate in *import prices for several industries* from their recent respective peak rates: industrial supplies, which includes fuels & lubricants (to -16.5% from 55.2%); foods, feeds & beverages (2.7 from 15.7); capital goods (0.8 from 4.2); and consumer goods ex autos (-0.1 from 3.2).

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