Yardeni Research

MORNING BRIEFING
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China: Party Tricks

Check out the accompanying chart collection.

Executive Summary: China's recent efforts to stimulate its economy are likely too little too late after a decade of capitalism-eroding policies under President Xi Jinping, a huge property bubble, and a rapidly aging population. August's economic data do show green shoots of revived growth from the stimulative policy initiatives recently enacted, but not convincingly enough to reinvigorate China's stock market or global commodity markets. The copper price in particular is highly sensitive to China's economic situation, but its range-bound price action suggests Dr. Copper is not impressed. … Moreover, China's forward revenues and earnings metrics have been trending downward since 2014, suggesting that China peaked back then.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

China I: Bad Policies. The Chinese Communist Party (CCP) has an implicit deal with the citizens of China. The CCP will deliver widespread economic prosperity with lots of jobs and rising real incomes. The citizens will accept less freedom under the authoritarian rule of the CCP. Their deal with the devil has worked so far. Never in the history of the world has the standard of living of so many people improved in such a short time as it did in China from the 1980s through the mid-2010s.

Ironically, much of China's prosperity during that period occurred when the CCP turned less authoritarian. The party allowed capitalism to flourish for a while, and so did the Chinese economy. However, in recent years, under President Xi Jinping—who has served as the undisputed supreme leader since 2012—the CCP has turned increasingly authoritarian and hostile to capitalism.

That transition has been occurring just as the Chinese economy has started to sputter. That's happening for several reasons:

(1) *Geopolitical tensions & trade*. The CCP under President Xi has turned increasingly bellicose in matters of international relations. The government has been building islands in the South China Sea to claim territorial sovereignty over more of the surrounding waters. The Chinese government has ignored the protestations of neighboring nations and others that dispute the practice as an illegal threat to international commerce.

The disruptions that occurred to global supply chains during the pandemic triggered a move toward onshoring that has weighed on China's exports to the rest of the world. Rising political tensions between China and the West over Taiwan and China's unfair business practices have convinced many foreign businesses that China isn't a reliable trading partner.

China's exports in yuan terms have been essentially flat since early last year (*Fig. 1*). China's imports have been flat since late 2020, reflecting the weakness of domestic consumption and the lack of stimulus from exports. The weakness in exports has been most pronounced for those going to advanced economies (*Fig. 2*). Some of that weakness was offset by stronger exports to emerging economies.

(2) *Anti-business policies.* Since 2021, Xi has been promoting a vision for the country he calls "common prosperity." It's a progressive framework that emphasizes reducing inequality, balanced regional development, and a healthy "spiritual and moral culture." Since then, the CCP imposed a rash of new regulations and fines on private capital and technology companies.

On July 1 of this year, the Chinese government substantially broadened its law on espionage. The changes "have raised legitimate concerns about conducting certain routine business activities, which now risk being considered espionage," Craig Allen, president of the US-China Business Council, recently *blogged*. "Confidence in China's market will suffer further if the law is applied frequently and without a clear, narrow and direct link to activities universally recognized as espionage."

(3) *Demographic issues.* The CCP's disastrous one-child policy, imposed from 1979 to 2015, has resulted in a rapidly aging demographic profile that is now weighing on economic growth. We've often described China as the world's largest nursing home. China's population is aging faster than those of nearly all other countries in modern history.

A March 22 *article* in Nikkei Asia reported: "By 2035, an estimated 400 million people in China will be age 60 and over, representing 30% of the population, according to the government's own projections. And the ratio of old to young is expected to rapidly grow more unbalanced after deaths outnumbered births last year, for the first time since 1961." China's population declined in 2022, plummeting by 850,000 to 1.412 billion (*Fig. 3*). China's fertility rate slipped to below 1.1 in 2022. A rate of 2.1 is required to sustain a population.

The rapidly aging population is weighing on inflation-adjusted retail sales in China. The 12-month average of the yearly percent change in real retail sales exceeded 10% from March 2005 through December 2014 (*Fig. 4*). It fell to 5.1% during December 2019, just before the pandemic. It's been fluctuating around zero since then. Older people with a grown child don't spend much money. Neither do married young adults, who must care for their older parents and maybe one child.

(4) *Property bubble.* For many years, one of the major drivers of Chinese economic growth was the property boom. The provincial governments sold land to developers, who built brand-new cities full of brand-new apartments, which were purchased as investments by Chinese households and often left vacant. The local governments used the revenues to build public infrastructure. That resulted in lots of economic growth and probably the biggest property bubble in history. The air is coming out of the bubble as the Chinese government scrambles to keep it from bursting. Developers are no longer buying more land, so the local governments are seeing their revenues dry up.

(5) *Youth unemployment.* In August, the Chinese government, rather than report an expected seventh consecutive monthly increase in youth unemployment, opted to suspend release of the information. The unemployment rate among 16- to 24-year-olds in urban areas hit 21.3%, a record high, in June and has risen every month this year through June. An August 15 *article* in *The New York Times* reported: "On top of the damage inflicted on the job market during the pandemic, the government cracked down on the country's technology, real estate and education industries, where educated young Chinese had flocked for jobs. The regulatory actions caused hundreds of thousands of layoffs and left companies and investors more cautious about expanding their businesses. When businesses are wary, hiring typically suffers."

China II: Same Old Tricks. Under pressure to get the economy growing faster, the Chinese government and related institutions have taken many small steps to encourage borrowing and lending and to bolster private industry:

(1) The government announced on September 4 plans to set up an agency to coordinate policies across various government bodies to help develop the private economy. This is quite a reversal from the Chinese government's stance toward private companies and financial markets in 2021, when it blocked the IPO of Ant Group. Additional moves that China made recently to facilitate financial market activity include halving the stamp duty, a tax charged on shares traded; restricting share sales by major shareholders under certain circumstances; and lowering margin requirements.

(2) To boost the property sector, the People's Bank of China (PBOC) and other agencies lowered the down payment for first-time home buyers to 20% and for second-time purchasers to 30%. Chinese state-owned banks are expected to help borrowers by lowering interest rates on existing mortgages or replacing them with new mortgages. Chinese banks cut deposit rates to encourage savers to become spenders, and the one-year loan prime rate was lowered by 10 basis points to 3.45% last month.

The PBOC's ability to cut rates is somewhat limited if it aims to keep the yuan from falling below its current decade-low level. The yuan traded at 7.3 to the dollar yesterday, down from its recent peak of 6.7 and its lowest level since early November 2022 (*Fig. 5*). It rebounded on Friday following a slew of better-than-expected economic indicators, as discussed below.

(3) Regulators also have lent a hand by cutting reserve ratios. At large depository institutions, the reserve ratio has fallen to 10.50% from 12.00% two years ago (*Fig. 6*). The latest cut of 25bps occurred on Thursday.

By cutting reserve requirements, the PBOC aims to stimulate more bank lending. That doesn't mean that banks haven't been lending. On the contrary, over the past 12 months through August, bank loans are up 22.6 yuan, or $3.2 trillion (*Fig. 7*). Indeed, China's economic growth since the end of the Great Financial Crisis has been fueled by lots of debt, especially bank loans. They've more than quintupled over the past 13 years, from $6.1 trillion at the start of 2010 to a record $32.4 trillion through August (*Fig. 8*). Over this same period, US bank loans only about doubled, from $6.4 trillion to $12.2 trillion through July.

China III: Green Sprouts vs the Red Metal. The latest batch of Chinese economic indicators, for August, suggests that the government's stimulative policy initiatives may be providing a lift to the economy. While these green shoots are sprouting, Professor Copper, the red metal with a PhD in economics, isn't convinced that the outlook for China's economy is improving much if at all. The nearby futures price of copper has been trading just below $4.00 per pound since early this year (*Fig. 9*).

The government's stimulus program announcements haven't caused China's MSCI stock price index in yuan to rally. Investors may be skeptical (as we are) that the CCP's old tricks for boosting the Chinese economy will work. Perhaps Friday's batch of economic indicators will rally stocks in the coming days and weeks.

Let's review the latest batch of economic indicators:

(1) Industrial output rose 4.5% y/y in August, accelerating from the 3.7% pace in July (*Fig. 10*). The growth marked the quickest pace since April. It suggests that Q3's real GDP will be up around 5.0% y/y.

(2) Retail sales also increased faster in August, at a pace of 4.6%, aided by the summer travel season; it was the quickest growth since May. That compared with a 2.5% increase in July. Inflation-adjusted retail sales rose 4.5% y/y (*Fig. 11*).

(3) Separate commodities data showed China's primary aluminum output hit a record-monthly high in August, while oil refinery throughput also rose to a record.

On the other hand:

(4) Fixed-asset investment expanded at a lackluster pace of 3.2% during the first eight months of 2023 from the same period a year earlier, versus 3.4% in the first seven months.

(5) For August, property investment extended its fall, down 19.1% y/y from a 17.8% slump the previous month, according to Reuters calculations.

(6) Government revenue from state land sales fell for the 20th consecutive month in August, finance ministry data showed on Friday, weighing on the already debt-laden local governments' finances.

(7) US and European firms are shifting investment away from China to other developing markets, a report from Rhodium Group showed, with India receiving most of this redirected foreign capital, followed by Mexico, Vietnam, and Malaysia. The September 13 Reuters *reported*: "These companies are turning their backs on the world's second-largest economy even as its share of global growth continues to increase, highlighting how concerns over China's business environment, economic recovery and politics weigh heavy on the minds of foreign investors."

The value of announced US and European greenfield investment capital flowing into India shot up by $65 billion, or 400%, from 2021 to 2022, the report said, while investment into China dropped to less than $20 billion last year, from a peak of $120 billion in 2018.

(8) China's CPI edged up by 0.1% y/y in August, reversing course slightly from a fall of 0.3% y/y in July (*Fig. 12*). Meanwhile, the drop in China's PPI narrowed from -4.4% in July to -3.0% in August. The PPI has fallen for 11 months in a row, reflecting the weakness in

China’s economy.

By the way, the China and US CPI inflation rates are highly correlated (*Fig. 13*). The same can be said about the two countries’ PPIs (*Fig. 14*). Some of America’s inflation is made in China, which has tended to have a disinflationary impact on the US.

China IV: Depressed Forward Metrics. Did China peak in 2014? The forward revenues of the China MSCI has been on a downward trend since 2014 after it soared dramatically during the previous 10 years (*Fig. 15*). The forward earnings of the China MSCI soared after the country entered the World Trade Organization in late 2001 (*Fig. 16*). This series has flattened since late 2011. The China MSCI stock price index rallied along with earnings from 2003 through 2007 (*Fig. 17*). It has been essentially flat, though volatile, since then.

Calendars

US: Tues: Housing Starts & Building Permits 1.440mu & 1.441mu; API Weekly Crude Oil Inventories. **Wed:** MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Interest Rate Decision 5.50%; FOMC Economic Projections. (FXStreet estimates)

Global: Tues: Eurozone Headline & Core CPI 0.6%m/m/5.3%y/y & 0.3%m/m/5.3%y/y; Eurozone Current Account Balance €30.2b; Canada CPI 0.2%m/m/3.8%y/y; China PBoC Loan Prime Rate 3.45%; Wuermeling. **Wed:** Germany PPI 0.2%m/m/-12.8%y/y; UK Headline & Core CPI 0.7%m/m/7.1%y/y & 0.7%m/m/6.8%y/y; UK PPI Input & Output Prices 0.2%/0.2%; UK House Price Index 1.5; Schnable; Jochnick; Panetta; Enria; McCaul; Elderson; Mauderer. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose last week for all three indexes simultaneously for a fourth straight week, matching the longest streak since April 2022. LargeCap’s forward earnings was at a record high for the first time in 63 weeks, dating back to the June 24 week of 2022. MidCap’s remains 4.6% below its record high in early June 2022; and SmallCap’s is struggling at 11.5% below its mid-June 2022 record. Through the week ending September 15, LargeCap’s forward earnings has risen 6.4% from its 54-week low during the week of February 10; MidCap's is 3.9% above its 55-week low during the week of March 10; and SmallCap's is 2.4% above its 72-week low during the March 17 week. These three indexes' forward earnings downtrend since mid-2022 has been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Forward earnings momentum remains near two-year lows but is no longer worsening. The yearly rate of change in LargeCap's forward earnings has improved to 0.9% y/y from a 29-month low of -3.2% y/y during the June 23 week. Those levels compare to a record-high 42.2% at the end of July 2021 and, on the downside, to -19.3% in May 2020, which was the lowest since October 2009. MidCap's rate of -4.3% y/y is up from a 31-month low of -5.9% in early June, which compares to a record high of 78.8% in May 2021 and a record low of -32.7% in May 2020. SmallCap's -9.2% y/y rate is up from a 32-month low of -12.9% in mid-June and down from a record high of 124.2% in June 2021; it compares to a record low of -41.5% in June 2020. Analysts' consensus earnings forecasts for 2023 and 2024 had been heading steadily lower since June of last year, but the 2023 estimate for the S&P 500 ticked higher during the Q1 and Q2 reporting seasons as analysts incorporated the strong earnings beats into their forecasts. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.5% and 12.0%), MidCap (-12.0, 13.4), and SmallCap (-11.0, 12.9).

S&P 500/400/600 Valuation (*link*): Valuations were mostly steady for these three indexes during the September 15 week. LargeCap's forward P/E dropped 0.1pt w/w to 18.5, and remains below its 18-month high of 19.6 during the July 28 week. It's up 3.4pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E was unchanged w/w at a 12-week low of 13.5, and is down from its 21-week high of 14.4 during the July 28 week. It's now 1.2pt below its recent 10-month high of 14.7 in early February and up 2.4pts from its 30-month low of 11.1 at the end of September 2022, which compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E remained at a 12-week low of 13.1, which compares to a 21-week high of 14.1 during the July 28 week and is now 1.2pt below its recent 12-month high of 14.3 in early February. It's up 2.5pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 27% discount to LargeCap's P/E remains near its 24-year-low 30% discount during the June 23 week. It had been at a 21% discount during the March 17 week, which was near its best reading since November 2021. SmallCap's 29% discount to LargeCap's P/E last week is not much improved from its 21-year low of 32% in April 2022. That compares to a 22% discount during the March 10 week, which was near its lowest discount since August 2021. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for an 118th straight week; the current 3% discount is near its lowest since July 2021 and an improvement from its 20-year-low 9% discount in December 2021.

S&P 500 Sectors Quarterly Earnings Outlook (*link*): Following the Q3-2020 earnings season, when the US economy emerged from the Covid shutdown, analysts began raising their consensus forecasts for future quarters instead of lowering them as is the historical norm. That six-quarter streak of positive revisions throughout the quarter ended during Q1-2022, and the estimate declines accelerated considerably for the three quarters through Q1-2023 before easing for Q2-2023. Looking at Q3-2023, the revisions pendulum has turned positive again as analysts have now increased their estimates since the beginning of the quarter 11 weeks ago. They're now forecasting that the S&P 500's earnings will rise 0.1% y/y in Q3-2023. That's up from a 5.4% decline in Q2-2023, which likely marked the cyclical bottom for earnings growth. On a pro forma basis, they expect a y/y earnings gain of 2.0% in Q3, up from a 2.9% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 7.3% y/y in Q3-2023, an improvement from the 3.6% gain in Q2-2023, the 1.6% decline in Q1-2023, and the 7.4% drop in Q4-2022. Seven sectors are expected to record positive y/y percentage earnings growth in Q3-2023, unchanged from Q2-2023's count. However, that's up from five sectors that did so in Q1-2023 and up from only two in Q4-2022. Here are the S&P 500 sectors' expected earnings growth rates for Q3-2023 versus their nearly final earnings growth rates for Q2-2023: Communication Services (34.5% in Q3-2023 versus 16.0% in Q2-2023), Consumer Discretionary (22.2, 55.1), Financials (15.3, 9.9), Utilities (13.1, 0.6), Industrials (10.3, 15.7), S&P 500 ex-Energy (7.3, 3.6), Information Technology (5.6, 5.0), S&P 500 (1.9, -2.9), Consumer Staples (1.4, 8.6), Real Estate (-6.8, -2.2), Health Care (-9.6, -26.7), Materials (-20.2, -26.4), and Energy (-37.0, -47.7).

US Economic Indicators

NAHB Housing Market Index (***link***): "High mortgage rates are clearly taking a toll on builder confidence and consumer demand, as a growing number of buyers are electing to defer a home purchase until long-term rates move lower," noted NAHB Chairman Alicia Huey. Homebuilders' confidence fell for the second month in September, sinking 11 points over the two-month period to 45—dropping back below the key break-even measure of 50 for the first time in five months, coinciding with the jump in mortgage rates above 7%. Confidence had jumped 25 points the first seven months of this year to 56. Confidence fell all 12 months of 2022, by 53 points, to 31—which was the lowest since the height of the pandemic. All three components of homebuilders' confidence have moved lower in recent months, current sales (-11 points to 51) and traffic (-10 to 30) have declined the past two months, while future sales (-13 to 49) has extended its string of declines to three months. On the supply side, builders continue to struggle with shortages of construction workers, buildable lots, and distribution transformers, adding to housing affordability concerns. According to the report, 32% of builders reported cutting home prices in September, up from 25% in August—and the largest share of builders cutting home prices since December 2022 (35%). The average prices discount remains at 6%.

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