MORNING BRIEFING
November 28, 2023

Xi's New Open-Door Policy

Check out the accompanying chart collection.

Executive Summary: China's economy is hurting, and the government's recent attempt to cozy up to the US—on display in President Xi's recent speech—reflects a dire need for more foreign direct investment. But to get it, the government may need to change its aggressive ways. … China's consumers are feeling the economic pain firsthand, with declining net worths affecting their spending. Two major crises led China to this juncture, one related to its flailing property market and the other to its aging and shrinking population. … US consumers, on the other hand, are flush with substantial net worth, especially the Baby Boomers.

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

China I: Gee, Why Does Xi Want To Play Nice? China's economy is in a property-led and fertility-led depression. That's bad news for China's people and for the Chinese Communist Party (CCP) but benefits countries that import Chinese goods at depressed prices. China's bad news is good news for the US in particular, helping to moderate goods inflation. It would be in China's interest to attract more foreign direct investment to shore up its economy. To achieve that, the Chinese government may have to become less confrontational in matters of foreign affairs, especially vis-vis Taiwan.

That backdrop might explain why Chinese President Xi Jinping delivered a very dovish *speech* in San Francisco on Wednesday, November 15 at the "Welcome Dinner by Friendly Organizations in the United States" that was framed to curry favor with America and not very subtly. He started by expressing his "sincere thanks to the National Committee on U.S.-China Relations, the U.S.-China Business Council, the Asia Society, the Council on Foreign Relations, the U.S. Chamber of Commerce and other friendly organizations for hosting this event. I also want to express my warm greetings to all American friends who have long committed to growing China-U.S. relations and my best wishes to the friendly American people."

The tone of the speech remained warm and fuzzy to the end. Xi nostalgically recalled how General Claire Lee Chennault led a group of American volunteers, known as the "Flying Tigers," to the battlefield in China against Japan during World War II. He mentioned the word “door” twice:

(1) “I am convinced that once opened, the door of China-U.S. relations cannot be shut again. Once started, the cause of China-U.S. friendship cannot be derailed halfway. The tree of our peoples’ friendship has grown tall and strong; and it can surely withstand the assault of any wind or storm.”

(2) “The door of China-U.S. relations was opened by our peoples. For 22 years, there were estrangement and antagonism between our two countries. But the trend of the times brought us together, converging interests enabled us to rise above differences, and the people’s longing broke the ice between the two countries.”

His comments harken back to the “Open Door Policy” statement of principles initiated by the United States in 1899 and 1900 for the protection of equal privileges among countries trading with China and in support of Chinese territorial and administrative integrity.

Xi declared: “China is ready to be a partner and friend of the United States. The fundamental principles that we follow in handling China-U.S. relations are mutual respect, peaceful coexistence and win-win cooperation.”

That’s all fine. However, what about China’s island-building in the South China Sea, threats to invade Taiwan, systematic repression of ethnic minorities in Xinjiang and Tibet, and unfair business and trade practices? They weren’t mentioned. Nor was the Law on Foreign Relations of the People’s Republic of China and the Anti-Espionage Law of the People’s Republic of China, both of which went into effect in July. The former increases the risk of prosecution for complying with sanctions against China imposed by other countries—like the US—if China believes the sanctions are counter to international law. The latter grants broad powers to the state to demand information from businesses operating in China and expands the definition of activities the government considers espionage.

With rising tensions between China and most other developed nations, it’s no wonder that foreign direct investment in China has come to a screeching halt. According to a November 17 *article* by VOA’s Rob Garver, in Q3-2023, direct investment liabilities in China’s balance of payments—a figure that tracks the movement of money connected to foreign companies—was a negative $11.8 billion. It was the first time since data collection began in 1998 that the figure was not in positive territory.

Obviously, Xi would like American capitalists to invest in China. As discussed in the next section, China's economy is in deep trouble. The good news is that might deter Xi and his CCP comrades from invading Taiwan anytime soon. Prices are falling in China's depressed economy, which is helping to bring inflation down in the US and other countries that still import lots of Chinese goods. This partly explains why inflation is moderating in the US without a recession (what we call "immaculate disinflation").

Xi even resorted to panda diplomacy during his November 15 speech. He said, "Pandas have long been envoys of friendship between the Chinese and American peoples. We are ready to continue our cooperation with the United States on panda conservation." If relations improve between China and the US, he might send back a few pandas that were recently returned to China.

China II: Big Negative Wealth Effect. The collapse of China's property market continues. According to a November 15 Bloomberg *post*, new-home prices (excluding state-subsidized housing) in 70 cities declined 0.4% m/m in October and 0.3% m/m in September, National Bureau of Statistics figures showed. October's decrease was the steepest since February 2015. The Bloomberg data show that new and second-hand home prices are down 3.4% and 9.3% at the end of October from their August 31, 2021 peaks.

The problems for the property market—which along with related industries accounts for about 20% of China's economy—began in 2020 when authorities laid out "three red lines." Those rules set leverage benchmarks that builders had to meet if they wanted to borrow more money. China's property crisis has engulfed almost all the largest developers. They have been struggling to repay debts and complete projects since a credit crunch emerged three years ago.

Such policies were intended to help curb years of excessive debt-fueled expansion by builders and property speculation by homebuyers. But they wound up tipping a record number of developers into default as refinancing costs surged.

The Shenzhen Real Estate stock price index peaked during 2020 on July 6. It is down 52.5% since then through Friday (*Fig. 1*). The China MSCI is down 54.5% since February 17, 2021 (*Fig. 2*).

Now there are signs of cracks in China's shadow banking system. On Monday, several employees of Zhongzhi Enterprise were arrested. The privately held conglomerate operates several businesses that sold investment products to many wealthy individuals and companies in China; it has struggled for months to make promised payments to investors.

With home prices and stock prices falling, China's consumers are experiencing a significant negative wealth effect on their spending. That is a particularly painful experience for China's older population.

China III: Rapidly Aging Population. The Chinese economy is also weighed down by its rapidly aging population. Chinese consumers are likely to spend less and save more to offset the erosion of their wealth as their holdings in real estate and stocks depreciate. Here are a few updates on China's demographic profile:

(1) In 2022, there were 956,000 births in China, the lowest on record (*Fig. 3*). That's down 50% from 10 years ago.

(2) The fertility rate (births per woman) has been below 2.00 since 1991. It was down to only 1.16 in 2021 (*Fig. 4*). The Chinese aren't having enough babies to replace themselves.

(3) As a result, the population is shrinking (*Fig. 5* and *Fig. 6*). It peaked during 2021 at 1.41 billion. It declined by 850,000 during 2022, the first decline since 1961.

US Consumers: Mortgage-Free & Shopping. Since early 2022, the diehard hard-landers have been predicting that consumers will retrench once they run out of the excess saving that they accumulated during the pandemic. We've countered that there are lots of people with substantial net worth saved for retirement. Now many of them are retiring.

There has never been a generation with as much in their retirement nest eggs as the Baby Boomers. Indeed, this cohort holds about half the $154.3 trillion in US household net worth (*Fig. 7*).

The Baby Boomers and other households have lots of their net worth in their houses. During Q2-2023, household residential real estate totaled $44.5 trillion, matching the Q2-2022 record high (*Fig. 8*). Household mortgages totaled $12.8 trillion, resulting in a near-record $31.6 trillion in owners' equity.

Since the Great Financial Crisis, the value of homes has increased faster than mortgage debt. As a result, on average, homeowners own 71.1% of their homes, up from 45.9% in Q1-2012.

Now here is the punch line: According to a November 17 Bloomberg *post*," The share of US homes that are mortgage-free jumped 5 percentage points from 2012 to 2022, to a record just shy of 40%, or 35 million households. More than half of these owners have reached retirement age. Freedom from mortgage debt gives them the option to age in place—or uproot to sunnier climes."

They also have the freedom to spend more of their earned and unearned income (such as interest and dividends) since they are free from having to pay a monthly mortgage fee. And of course, many of the 50 million homeowners with mortgages refinanced them at record-low rates during the pandemic. So their monthly payments are low.

Calendars

US: Tues: Consumer Confidence 101; Richmond Fed Manufacturing Index 1; S&P/CS HPI Composite 20-City Index 4.2%y/y; API Weekly Crude Oil Inventories; Barr; Bowman; Waller. **Wed:** GDP & Price Index 4.9%/3.5%; Real Consumer Spending & PCE Price Index 4.0%/2.9%; Corporate Profits; Goods Trade Balance -$86.7b; MBA Mortgage Applications; Wholesale Inventories 0.1%; Crude Oil Inventories & Gasoline Production; Natural Gas Storage; Beige Book; Mester. (FXStreet estimates)

Global: Tues: Germany Gfk Consumer Climate -27; France Consumer Confidence 85; Italy PPI; Japan Core CPI 3.4%y/y; Lagarde; Lane; McCaul; Nagel; Adachi. **Wed:** Eurozone Business & Consumer Survey 93.8; Eurozone Consumer Confidence -16.9; Germany CPI -0.2%m/m/3.5%y/y; Germany Import Prices; France Nonfarm Payrolls -0.1%; Spain CPI 3.7%y/y; Italy Business & Consumer Confidence 96.0/102.0; Italy PPI; Japan Industrial Production 0.8%; Japan Retail Sales 5.9%; China M-PMI & NM-PMI 49.6/51.1; European Central Bank Non-monetary Policy Meeting; Bailey; Nakamura. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings rose simultaneously for all three of these indexes for the first time in six weeks. LargeCap's forward earnings rose 0.6% w/w to a new record high after first hitting that mark during the September 15 week for the first time in 15 months, dating back to the June 24 week of 2022. MidCap's rose 0.1% w/w to 5.3% below its record high in early June 2022, and SmallCap's edged up less than 0.1% w/w to 10.9% below its mid-June 2022 record. Through the week ending November 17, LargeCap's forward earnings has risen 7.8% from its 54-week low during the week of

February 10; MidCap's is 3.1% above its 55-week low during the week of March 10; and SmallCap's is 3.1% above its 72-week low during the March 17 week. These three indexes' forward earnings downtrends since mid-2022 have 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 steadily ticking higher now. The yearly rate of change in LargeCap's forward earnings has improved to a 13-month high of 5.8% 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 0.7% y/y is at a nine-month high and 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 -3.9% y/y rate is also at a nine-month high; it's 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. During the Q3 season so far, they've kept LargeCap's 2023 estimate little changed and have trimmed SMidCap's. Here are the latest consensus earnings growth rates for 2023 and 2024: LargeCap (1.3% and 11.4%), MidCap (-13.1, 11.1), and SmallCap (-9.1, 8.3).

S&P 500/400/600 Valuation (*link*): Valuations edged up for these three indexes during the November 24 week. LargeCap's forward P/E was up 0.1pt w/w to a 12-week high of 18.7 and is up from a seven-month low of 17.0 during the October 27 week. That's down from its 18-month high of 19.6 during the July 28 week. It's still up 3.5pts 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 rose 0.1pt w/w to a 12-week high of 13.5 and is up from a 12-month low of 12.1 at the end of October. It's now 1.2pts below its 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 rose 0.1pt w/w to a 10-week high of 12.9 and is up from a 12-month low of 11.3 at the end of October. It's now 1.4pt below its recent 12-month high of 14.3 in early February. It's up 2.3pts 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 28% 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 31% discount is up from a 23-year-low 34% discount a week earlier, which compares to a 22% discount during the March 10 week; that one 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 a 128th straight week; the current 5% discount is 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 turned slightly negative w/w in the usual performance right before the start of the earnings season ahead of the typical earnings surprise hook. They're forecasting that the S&P 500's earnings rose 3.9% y/y in Q3-2023. That's up from a 5.8% 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 7.1% in Q3, up from a 2.8% decline in Q2-2023. S&P 500 ex-Energy earnings are forecasted to be up 12.6% 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 blended earnings growth rates for Q3-2023 versus their final earnings growth rates for Q2-2023: Communication Services (46.5% in Q3-2023 versus 15.7% in Q2-2023), Consumer Discretionary (42.3, 57.0), Financials (23.5, 9.3), Information Technology (14.9, 5.0), Industrials (12.0, 15.7), S&P 500 ex-Energy (12.6, 3.6), Utilities (10.3, 0.6), S&P 500 (7.1, -2.8), Consumer Staples (6.7, 8.5), Real Estate (-5.4, -2.1), Health Care (-17.3, -26.7), Materials (-18.1, -26.4), and Energy (-33.0, -47.5).

US Economic Indicators

New Home Sales (*link*): New home sales (counted at the signing of a contract) declined more than expected in October, as high mortgage rates reduced affordability, though the shortage of existing home sales on the market serves as a buffer for the new home market. New home sales can be volatile from month to month; they dropped 5.6% last month, to 679,0000 units (saar), following a gain of 8.6%, a loss of 9.1%, and a gain of 6.6% during the prior three months. These sales are 17.7% above a year ago. Regionally, sales were a mixed bag during the month of October, though were in the plus column versus a year ago: Northeast (13.2% m/m & 10.3% y/y), South (2.1 & 19.2), Midwest (-16.4 & 8.5), and West (-23.3 & 18.9). Of the 679,000 homes sold in October, 279,000 had been completed, 287,000 were under construction, and 113,000 hadn't been started. Of the 439,000 homes for sale during October, 76,000 had been completed, 257,000 were under construction, and 106,000 hadn't yet broken ground. The months' supply at the current sales rate rose to 7.8 months, near its recent low of 7.1 months in July; it was at a recent peak of 10.1 months last summer. In October, 36% of smaller builders reduced home prices, up from 32% the previous two months, the highest share of builders cutting prices during this cycle, according to NAHB.

Regional M-PMIs (*link*): Four Fed districts so far have reported on manufacturing activity for November—New York, Philadelphia, Kansas City, and Dallas—and collectively they showed a slowing in the rate of decline. *Manufacturing activity* (to -4.7 from –10.2) contracted at the slowest pace since last July, as the New York (9.1 from -4.6) region moved from contraction to expansion, while the Kansas City (-2.0 from -8.0) and Philadelphia (-5.9 from -9.0) measures were less negative. The Dallas (-19.9 from -19.2) area continued to contract at a fast pace. *New orders* (-6.0 from -7.7) declined at a steady pace, not far from the breakeven point of zero, as New York (-4.9 from -4.2) billings continued to contract at a steady pace, while Philadelphia's (1.3 from 4.4) continued to expand at a sluggish pace and the Kansas City's (0.0 from -22.2) stabilized after a steep contraction. Meanwhile, orders in the Dallas (-20.5 from -8.8) region contracted at a much faster rate. *Employment* (-0.4 from 2.5) continued to hover around the breakeven point of zero, returning to negative territory this month after a brief move above zero, as factories in the Dallas (5.0 from 6.7) region continued to hire at a steady pace, while Philadelphia (0.8 from 4.0) hirings were at a near standstill. Meanwhile, New York (-4.5 from 3.1) hirings swung from positive to negative, while Kansas City's (-3.0 from -4.0) continued to fall at a slow pace. Looking at *prices-paid* indexes, the Philadelphia (14.8 from 23.1) measure has eased the past couple of months, after a brief move up to 25.7 in June, while the New York (22.2 from 25.5) and Dallas (12.6 from 13.6) measures are increasing at a steady pace. Meanwhile, while Kansas City's (7.0 from -2.0) accelerated from October's dip into negative territory. *Prices-received* indexes saw New York's (11.1 from 11.7) hold steady, though up from July's three-year low of 3.9, while Philadelphia's (14.8 from 14.6) measure held steady just above 14.0 for the fourth month, down from May's recent peak of 23.0. Kansas City's (-3.0 from 0.0) measure continued to hover around zero, up from July and August readings of -7.0 and -6.0, respectively, while the Dallas measure (-6.2 from -2.1) remained in negative territory.

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