Chess, Checkers, or Go? What is China's Next Move?

The Chinese economy is struggling. We can take that as a fact given the latest "official" economic data and all the anecdotal evidence to support this (including most banks revising their Chinese growth forecasts lower).

The major Chinese indices are flat on the year (about -5% in dollar terms) and are down 5% in the past month as whatever excitement was left regarding the re-opening trade has evaporated.

What will China do to "fix" this problem?

That is the question facing the global economy and markets. What can China do? What will they likely do? And how will it impact others? This is a "game" where China's moves will impact us, so let's think about what their strategy could (or should) be.

Starting Conditions

The "game" has been played for some time, bringing us to the current state of the board. While we don't need to analyze every piece, we do need to look closely at some of the more important pieces.

- **The re-opening "myth" or failure**
  - **The economy was partially open to begin with**. While not 100% open, it wasn't entirely closed either. The perception of 0 to 100 was too optimistic when the reality was more like 60 to 100.
  - **Xi's hand was forced.** The official plan had been to keep various lockdowns in place, but a series of protests forced Xi's hand. I'm not sure if that reduced the impact of the re-opening (since "central planning" wasn't fully behind it), but it seems worth thinking about. This is especially important as we try to figure out China's next move, which is likely going to be driven by "central planning".
  - **Companies (and countries) are retreating from China.** This has been a long-running theme here at Academy. It started with (tacit) support of tariffs and gained momentum during COVID, but it was really pushed over the edge by Russia's invasion of Ukraine and China's subsequent actions. **It isn't enough for China to make production available again, it requires companies to want to use their production facilities and that interest is NOT returning.** Not only have companies been forced to deal with unexpected risks associated with manufacturing in China (i.e., draconian lockdowns), but also everyone seems to be painfully aware that IP theft was likely worse than expected (regardless of how much effort went into protecting it). The opportunity to sell into China is more "smoke and mirrors" than reality. **THIS IS INCREDIBLY IMPORTANT AS IT REDUCES CHINA'S OPTIONS TO RESTIMULATE THEIR ECONOMY.**
- **The "domestic consumption" driven economy**
  - **The Chinese consumer has not learned to consume like the U.S. consumer** (though, to be honest, no one consumes like the average American does). Whatever hopes that China could develop a truly thriving and domestic "consumption driven" economy continue to fade. Yes, there is likely a mix of policy issues (both domestic and foreign) impacting the Chinese consumer and their ability or desire to consume. I don't see this changing any time soon as it is ingrained into the behavior of the population.

  - **Real estate is a major problem.** As we saw during the Great Financial Crisis, even Americans consume less when the value of their real estate is plummeting. It is incredibly difficult for anyone (both from a monetary point of view, but also from a psychological standpoint) to spend and consume when their largest asset is evaporating before their eyes. **THIS IS A PROBLEM THAT CHINA NEEDS TO ADDRESS TO STEM THE BLEEDING IN THEIR ECONOMY.**

- **No Contagion – yet**
  - **The "shadow banking" system is under pressure.** Some cracks have appeared in the shadow banking system. Trust companies linked to Zhongzhi Enterprise Group have missed payments on a variety of products sold to investors. Evergrande bonds are also trading in the single digits. So far, the problems seem to be contained, but this is when I pound on the table and try to remind everyone that **Lehman was NOT a moment**. The Bear Stearns-backed hedge fund had trouble in the spring of 2007 (almost 18 months before Lehman went under). There was a series of defaults (and deals done to avert other defaults) but nothing could stem the tide. **The Fed (and ECB from their own experience) have learned to act early and aggressively to stop the flow.** The immediate and overwhelming responses to Silicon Valley Bank (depositor protection, new programs for other banks, etc.) are examples of the Fed putting into action what they learned from the GFC, where arguably they were always a step behind and never got ahead of the crisis. **Did China learn from the GFC and the European Debt Crisis, or will they repeat the mistakes that we experienced back then?**

What Their Strategy Needs to Solve For

So, China has analyzed the board and understands a few things that a successful and effective policy will need to overcome.

- **Address real estate**. They need to do something to support individuals and families who are exposed to real estate losses. I don't think that "cheaper" rates, or "lower down payments" will help much right now because as we have seen, that doesn't matter if people believe that the value of their underlying asset will keep going down. This is a big part of why large-scale asset purchases (formerly known as Quantitative Easing) have become such a core part of monetary policy. This approach gets to the root of the problem and helps support asset prices directly. **I am not sure how China will do this, but look for some form of stimulus to support real estate.**

- **Ring fence the weak property companies and the smaller "shadow banking" entities**. I am not sure that China has the stomach for this. So far, it seems to be contained without taking action, which in theory is a good thing. I just have a strong belief that without action, you run a real risk of a domino effect where it starts with companies that no one has ever heard of and ends with household names under pressure. Any assistance for the real estate market also helps reduce the contagion risk. **If China makes a mistake, it could be that they are too complacent about this risk as they lay out their next moves**.

- **Build it and they will come doesn't work any longer**. I don't think that any amount of subsidies, favorable treatment, or even promises will encourage foreign manufacturers to return to China wholeheartedly. That ship (both figuratively and literally) has sailed. If they can't encourage manufacturers to come to them, then the logical step is for them to sell their finished goods elsewhere (this has been a theme of the T-Reports for months and is something that many clients want to learn more about). This is the "**from made in China to made by China**" theme. There are examples of this in action already and it is logical to assume that China sees this as an obvious path out of their economic doldrums. Interestingly, **we've now had several conversations with U.S. companies who have been "offered" the opportunity to conduct business in parts of South America in yuan**. More and more, I'm thinking that countries that have trade surpluses with China (commodity rich nations) will want to reduce their exposure to the yuan. One way to do that would be to buy finished goods from Chinese manufacturers. **The "rise of the Chinese brand" seems likely to be the next phase in China's growth**. Whether it works or not remains to be seen, but I see no way around China trying to implement this strategy (even more than they already have). Huawei is the poster child for this strategy, though that effort likely had some national security elements as well as economic factors backing the support against the company.

Crumbling Belts and Roads

General (ret.) Robeson has pointed out that in Africa (in particular), some of the massive Belt and Road Initiative projects are already starting to crumble. What he is seeing and hearing is that in some cases, the water had so many impurities that the concrete never set to the standards needed. Now, projects are seeing their potential lifespans become significantly reduced (which raises many questions). Some of these questions have been discussed in the past and some are relatively new, but all of them are potentially important.

- **Allies, clients, and vassals**. I think that we can safely say that China doesn't have allies the way that the U.S. does (NATO is just one example). The big question, which may get answered, is whether they have "client states" (important economic ties, but largely arms-length and with some degree of respecting each other's rights) or "vassal states" (largely controlled by China). We have been largely in the "client state" camp, but **as some of these projects potentially fail, we may be able to determine if the relationship was benign or not**.
- **Economic colonization**. What hasn't been tested is what happens if a country chooses not to follow through on supplying commodities secured through the Belt and Road Initiative. This would go beyond projects that are potentially failing to projects that are working as planned. In this case, the leadership decides that they have more interesting customers (away from China). This is a question that is starting to come up in our geopolitical discussions. **How far would China go to ensure the flow of resources that they've contracted for?** Taiwan still gets the most attention from a military standpoint, but more people are starting to wonder how and where China's burgeoning military could be used. They continue to expand their ability to use the man-made South China Sea islands (just one example). Just like we think that China has "client states" rather than "vassal states", we see the Belt and Road Initiative as "above" economic colonization. That might be something that we need to watch closely.
- **The Belt and Road Initiative as "predatory lending"**. We get into a lot of discussions about what happens if too many of the Belt and Road Initiative loans go unpaid.
    - One side argues that China needs the money and it will hurt them economically.
    - The other side (and you know that this is the side I'm on) thinks that they are indifferent to defaults at best and may even encourage them because that brings the other side to the negotiating table. China can extend terms, forgive some debt, reduce rates, etc. in return for favors (like allowing military ships in ports) that may have more value to China

and could never have been achieved by traditional political negotiations. The lending and inability to pay creates opportunities for China to benefit in ways that would have been unachievable otherwise (i.e., the price of the access is actually cheap).

We will learn a lot about how China wants to position itself globally on the political front in the coming months. They have been getting more involved (Saudi Arabia/Iran, Russia/Ukraine, Taiwan) and I expect that trend to continue, which also fits the narrative of China switching gears from being the world's factory to finishing and selling goods.

Bottom Line

Stimulus

- Some support will be provided to help consumers (lower rates). Other support will be provided to help banks (lower reserve requirements). Finally, some support will be provided to help real estate/shadow banking directly. They will believe that these steps will help enough and that there is minimal risk of contagion (and they will be wrong on both fronts).
- A medium positive for risk assets and a small negative for bonds as yields should push higher.
- The wildcard is addressing the real estate market and if they surprise me on this, we could see a bigger "risk on" trade globally.

Support for domestic goods producers

- Regarding "dumping" or allegations of "unfair" support, I am not sure whether this will be explicit or something that we just hear through the grapevine. Now that people are paying attention, we will get a lot more evidence (both anecdotal and visible) that this is occurring.
- This is potentially **deflationary** as Chinese products will likely "compete on price" (especially if subsidized) forcing global companies to also compete on price. This should largely be limited to countries that don't have a lot of wealth (or where the wealth is disproportionately held by a few people, i.e., bad Gini coefficient countries) and there is an extra bias towards those nations that have trade surpluses with China.
- I would examine companies in your portfolio that could be exposed to this sort of competition as it could hurt earnings.

Ongoing Reduction of Treasury Holdings

- To fund this, I expect that China will continue to reduce its exposure to U.S. Treasuries (we discussed TIC data in Lies, Damned Lies, and Statistics). This will put some pressure on U.S. Treasury yields, though only at the margin and towards the front end of the curve.

More Yuan Weakness

- The "defense" of the yuan is good theater, but if you are trying to bump up exports of your finished goods, a cheaper currency doesn't hurt.

Sabre Rattling

- There is a chance that China reaches out to the U.S. to reduce tensions, but I'd bet that we are more likely to be surprised by China flexing its muscles rather than working with us.

Lots of moving parts, but China's next moves should be interesting!

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