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Markets in High Resolution

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Down Goes China!

"I think he hurt Joe Frazier. I think Joe IS hurt. ***Down goes Frazier! Down goes Frazier! Down goes Frazier!***

That was Howard Cosell's iconic call in 1973, when a 29-0 Joe Frazier entered Madison Square Garden favored to defend his heavyweight title, but quickly found himself outmatched by a younger, stronger George Foreman. What many may not recall is that the famous "down goes Frasier" call came not at the fight's end, but a mere two minutes in. Badly stunned, Frazier gamely rose to continue through not one, not two, but *five more knockdowns* before the fight was mercifully called in the second round.

I'll give the Chinese economy credit. Like old Joe Frazier, its one tough sucker. Each time it gets knocked down it gets up again - a little wobblier in the knees, vision increasingly blurred – in an impressive, but ultimately futile display of fortitude.

Struggling to get off the mat, the Chinese economy is very close to going down for the count.

- Calls for credit stimulus will remain unheeded
- Lack of global reflation is a heavy drag
- Economy is in controlled deceleration but at risk of hitting "stall speed"
- China's rope-a-dope strategy

Stimulus Calls to Remain Unheeded

Chinese policymakers continue to signal a reluctance to engage in aggressive credit stimulus.

First came a spate of bank forecast downgrades to 2020 GDP to the 5.5-5.7% range, indicative of official "guidance." Said guidance was confirmed by comments this week from Premier Li Keqiang that the economy faced "certain downward pressure" and that it had become "very difficult" for the economy to grow at 6% or more.

As I laid out in June (China Stimulus: More Smoke & Mirrors), aggressive credit stimulus would be:

- An embarrassment for Xi Jinping
- Problematic for the RMB
- An economic dead end
- At high risk of failure due to weakened systemic credibility
- Foolish with limited prospects for a natural economic upturn on the horizon (you don't start a "long march" with an all-night bender)"

Stability Freaks: A fourth aggressive credit stimulus in a little over a decade entails a degree of potential economic instability that is unacceptable to Chinese leadership. **They would prefer a slower-growth economy that** (in their perception) **is less vulnerable to instability**.

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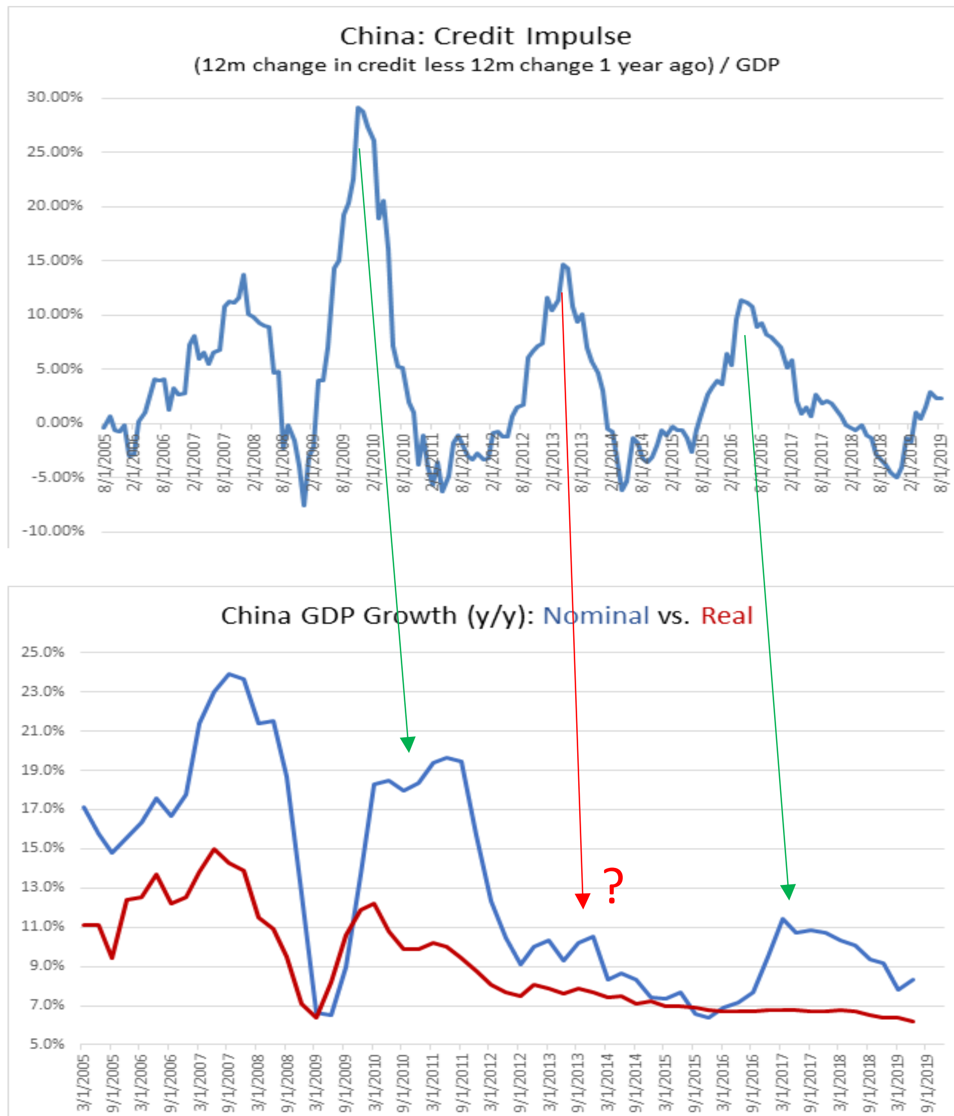
<u>A Rebound Requires Either Global Reflation or RMB Devaluation</u>

China's heavily managed real GDP growth rate belies **significant swings in nominal GDP growth, which determine debt-servicing capacity**:



How come nominal growth jumped in response to the 2009 and 2016-17 stimulus efforts, but **failed to respond to the 2013 stimulus** effort? Because of the commodity price backdrop.

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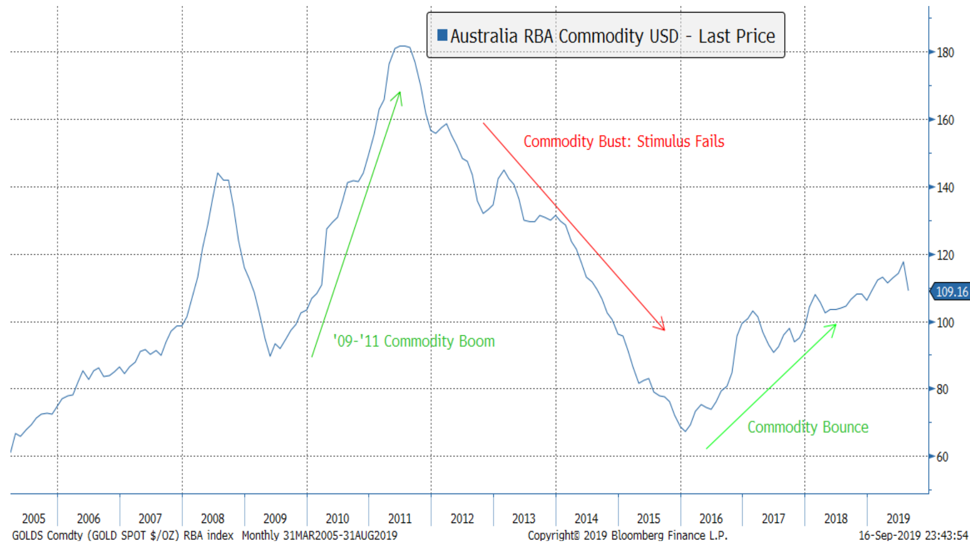
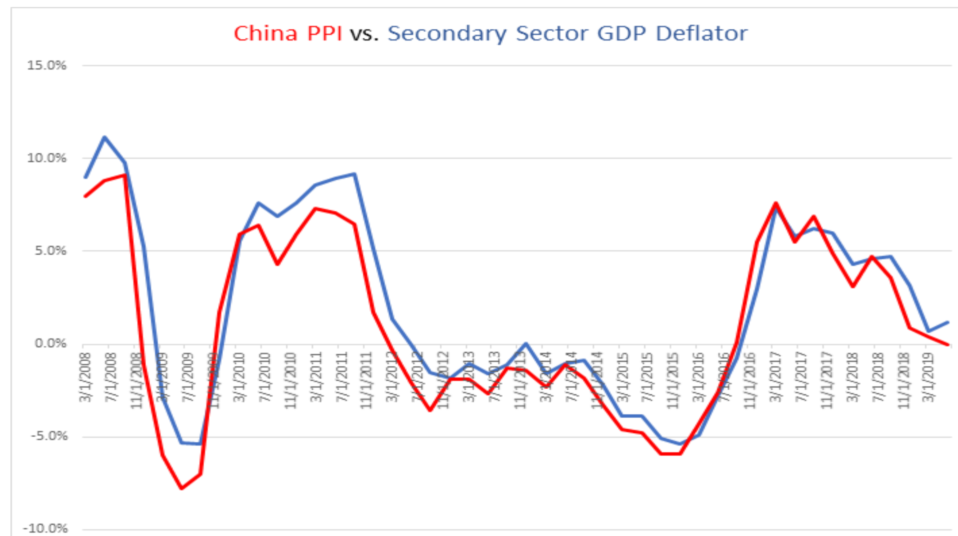
Commodity prices are the predominant driver of swings in China's GDP deflator, and hence nominal GDP growth:



In the "Secondary Sector" of China's economy (heavy industry, manufacturing and assembly) – where the bulk of the debt-servicing problems are - **the GDP deflator is essentially the PPI**…



…and China's PPI is essentially a global commodity price index:

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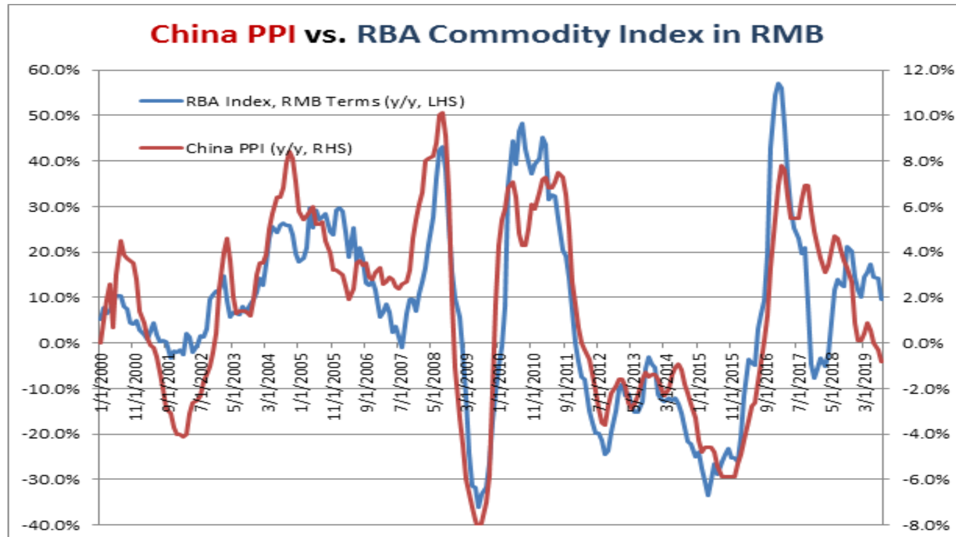

So long as the RMB remains quasi-pegged, **China's PPI inflation rate is exogenous**. It's determined by swings in global commodity prices, which are in turn driven by global liquidity conditions (as predominated by the U.S. Federal Reserve).

Of course, if USD commodity prices don't rise, China can always generate an increase in RMB terms by depreciating the RMB. **But any RMB depreciation would have to be significant to move the needle on China's nominal growth rate**. Each 1% increase in the RMB-denominated commodity index generates a PPI increase of only 18 basis points.

Absent acquiescence to a double-digit decline in the RMB, **China remains heavily exposed to global liquidity conditions**.

The Slowdown Remains Controlled – For Now

How long can Chinese policymakers maintain a controlled deceleration before hitting "stall speed?" There are three obvious sources of potential dislocation:

- Credit panic
- A break in real estate sentiment
- A messy resolution in Hong Kong

Credit Panic

China's credit bubble is the biggest and baddest the world has ever seen. What else would one expect from two decades of high-teens credit growth, all centrally planned amidst near-universal moral hazard?

Nonetheless, **I discount the risk of a financial dislocation stemming from credit market panic**. The reasoning has been presented in China: Where the Credit Risk Goes (7/31/19).

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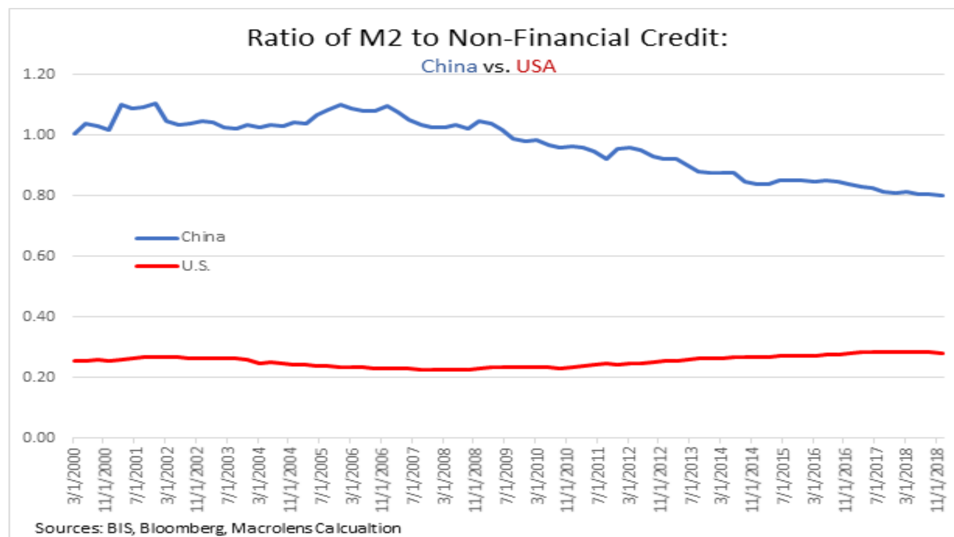
The Chinese credit market is bank-dominant – and the banks are state-controlled. **Think of China's banking system as one massive bank, with PBoC as the head office, and ICBC, CCB et al as "branches."**



Credit market dislocations as seen in market-based financial systems can't happen in China.

Shadow banking is still small enough to be absorbed onto bank balance sheets if needs be, with PBoC providing both the requisite funding and capital forbearance (or fudging).

And forget about a counterparty-risk panic in the interbank market. PBoC will simply call the banks and tell them they have to keep lending to dodgy counterparties.

Credit market stresses could force the PBoC into liquidity actions that put pressure on the RMB, but they are unlikely to cause policymakers to lose control of the pace of economic slowdown.

Real Estate Sentiment: Don't Ask Me

Sentiment towards Chinese real estate has so long ago passed the point of rationality that I see little use in further speculating on when it might crack. For all we know it is cracking right now - I don't trust the Chinese housing data much at all.

It's an open secret that **some significant portion of residential real estate sales aren't sales at all – they're collateralized borrowings**. Cash-strapped developers post apartments as collateral for loans, booking the transactions as "sales," while neglecting to disclose the related repurchase commitment. While reported transaction volumes have flatlined for two years, **we have no way of knowing what portion of these transactions are actual end-sales or repo transactions**.

And home price data showing a 9.1% year-on-year increase for August is out of whack with everything else we're hearing about the Chinese economy. I find it non-credible:

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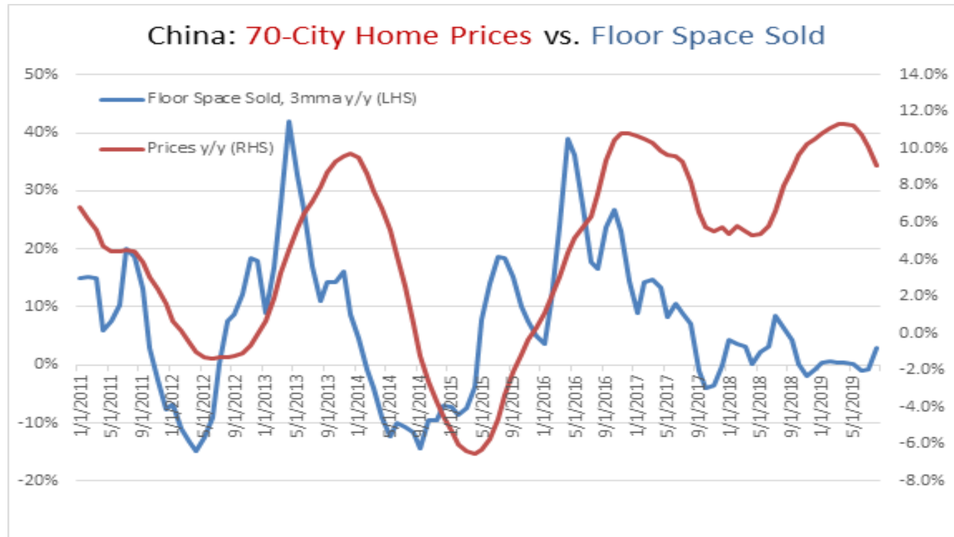
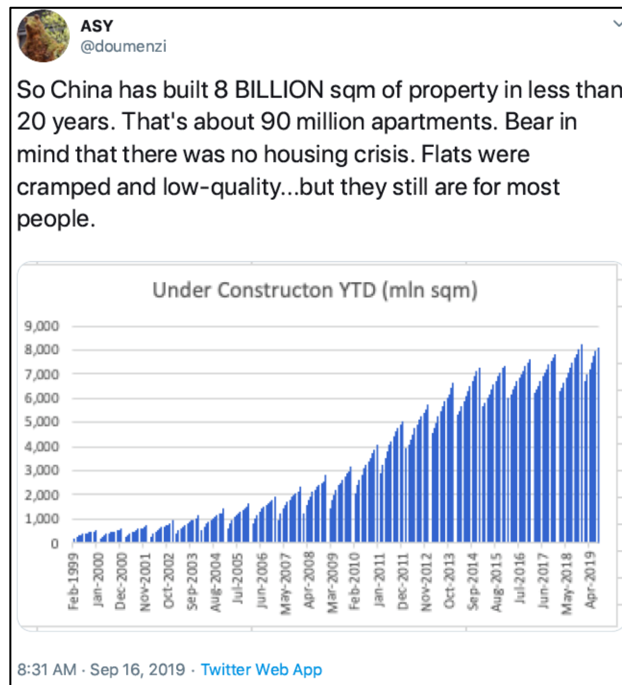


The logic of a slow-growth economy, extreme over-building, and official displeasure with sky-high price-to-income ratios will inevitably turn the public into an aggressive net seller *at some point*. Unfortunately, I see no sound basis for predicting exactly when that might happen.



A break in real estate sentiment would further impair the finances of land-sale dependent local governments, accelerating the vicious cycle between land sales, infrastructure spending, growth, and sentiment. The only deterrent to a debt-deflation spiral would be a heavy dose of PBoC-accommodated credit creation. **A sharp break in real estate sentiment would badly damage the RMB.**

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Hong Kong Remains a Live Tail

As detailed in Worried About Hong Kong (8/15/19), any overt Chinese intrusion into Hong Kong:

- marks the end of "one country, two systems"
- cements and accelerates the trend towards "decoupling."
- threatens asset market collapse in Hong Kong
- greatly exacerbates China's extant credit, real estate and capital flow problems
- raises the risk of more extreme China-related tail events (e.g. Taiwan)

October 1st is likely to bring renewed energy to the protests. Furthermore, Congressional passage of the Hong Kong Human Rights and Democracy Act seems inevitable – surely a catalyst for inflaming tensions.

A Chinese intrusion into Hong Kong would be a watershed event to accelerate decoupling, force further closure of the Chinese FX market, and risk a sudden stop of the Chinese economy. I struggle to see the situation ending well. I'm hedging my book with Dec 22 EWH Puts.

China's Rope-a-Dope Strategy

There is little upside to China in executing an aggressive credit stimulus against a backdrop of unfavorable global liquidity conditions. To return to the boxing analogy, that would be like continuing to attack the stronger, bigger opponent while getting your face beaten in. A change of tack is required.

The "rope-a-dope" strategy was devised by Muhammad Ali to take the title from the undefeated Foreman in the famous "Rumble in the Jungle" in Zaire in 1974. Rope-a-dope calls for a defensive posture, allowing the more aggressive fighter to repeatedly land non-damaging blows against the hands, arms, and body, with the energy defrayed by the elasticity of the ropes. As the offensive boxer tires himself out, the rope-a-doper looks for windows of brief but effective counter-action.

China's rope-a-dope is intended to stay upright and stretch out the action until the U.S. economy "tires itself out" in the form of recession, which would bring a weakened U.S. Dollar and easier global liquidity conditions. That would create a window for China to engage in offensive action – renewed credit stimulus, bad debt write-downs and some controllable RMB depreciation – without exposing its chin.

Place Your Bets

The rope-a-dope strategy is China's only chance to avoid an economic knockout.

But I'm betting that the Fed will do just enough to skirt a U.S. recession, while the frightened narrative of "trade uncertainty" burns itself out. As it becomes clear that the U.S. economy remains on a 2% footing, China will be enticed off the ropes in an attempt to force the action ahead of November 2020. It'll be a dangerous but necessary gambit.

Give me Trump in a knockout in the sixth round.

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