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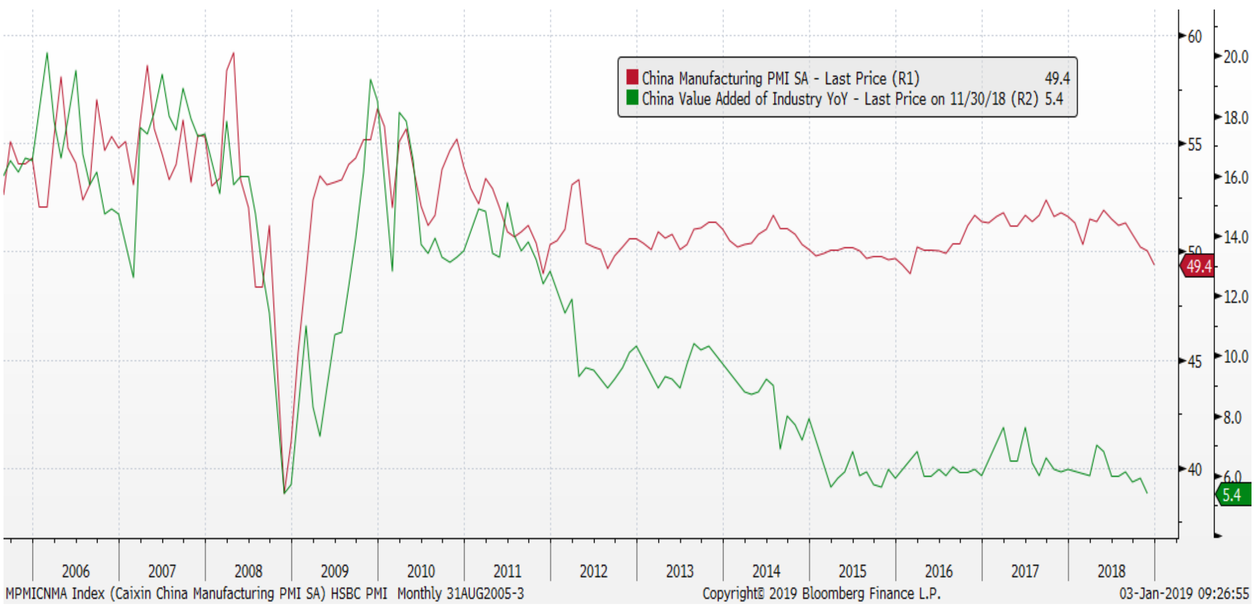
Is China Imploding?

- Its *possible* the Chinese economy is experiencing a "sudden stop"
- But stimulus remains "in the holster"
- Ignore RRR cuts. Watch credit growth.
- A trade truce and a Fed pause may provide a window for stimulus

The Chinese economy *might* be experiencing a "sudden stop." While that term is generally used to refer to a sudden cessation of foreign capital inflows, the end-game to the Chinese credit bubble was always likely to involve a break in confidence of local creditors and intermediaries. It's possible this end-game has now begun. China's PMI and the APPL profit warning are fueling extreme levels of China angst.

That said, China's PMI (red line below) isn't a terribly useful indicator. It completely missed the 2012-2015 deceleration in growth (green line is IP) and more recently was pointing to an upswing that never really materialized in the broader data sets. If it keeps trending towards 45 we'll know something unusual is going on.



The Apple profit warning may be a more notable signal of the Chinese economy "hitting a wall," but Apple's unique position at the epicenter of the trade spat blurs this news a bit. Tim Cook in his CNBC interview clearly attributes the weakness in Chinese sales to the growth slowdown which he suggests has been exacerbated by the trade tensions. If we take him at his word, it sounds more like consumer

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demand hitting a cliff than any type of Apple-specific consumer revolt stemming from the Huawei dust-up.

Domestic anecdotes are also as bleak as I can remember, with Baidu's CEO suggesting that "winter is coming" as a result of economic restructuring and the Chairman of China Construction Bank declaring that "there no money to be made" in residential property markets any more. There is also widespread chatter of multi-month plant shutdowns occurring around the Lunar New Year, which could have effected the surprisingly weak December PMI print.

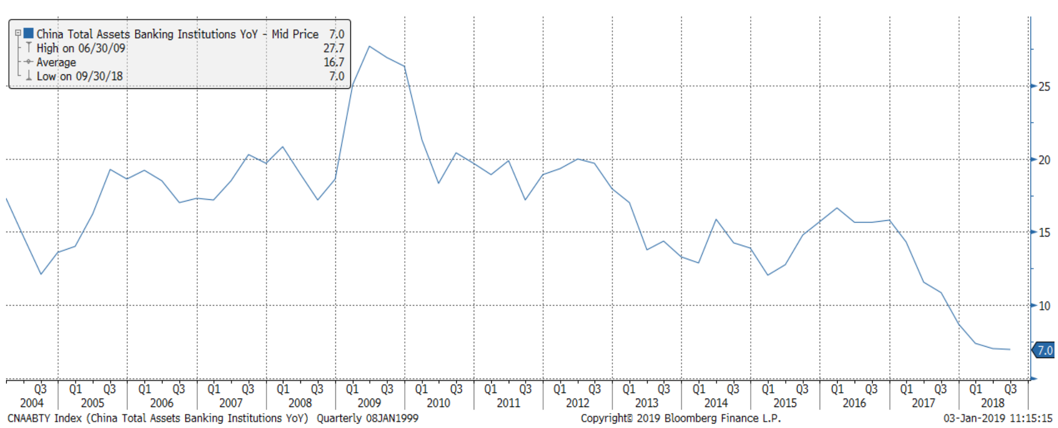
While assessments of the Chinese economy necessarily entail an element of guesswork, I'd broadly agree with CEA Chair Kevin Hassett, who said this morning that "the Chinese economy is slowing in a way that I haven't seen in a decade."

While I fully anticipate a "trade deal" that entails a 6-9 month calming of tensions, I would not look for that to fix what ails the Chinese economy. The confidence genie won't be put back into the bottle by a deal that (as seems likely) leaves the current tariffs in place and maintains the threat of more at any signs of Chinese economic misbehavior (which is inevitable).

And don't hang your Chinese recovery hat on "tax cuts" or "RRR cuts" either.

Unless the tax cut takes the form of a multiple-point cut to the VAT its unlikely to much help Chinese private businesses who are burdened with myriad charges both above and below board. Clearly the much-touted 2018 tax cuts (which actually steepened the marginal rate structure) haven't turned things around. Putting a few Yuan in people's pockets in the face of a possible collapse in systemic confidence isn't going to cut it.

Also, don't get too excited the recent "targeted RRR cut." Cuts to the required reserve ratio are a passive response to banks hitting liquidity constraints. Growth in bank assets naturally requires increased reserve holdings over time. The PBoC has established an array of liquidity facilities to provide liquidity on demand, but tapping these facilities generally requires collateral and entails some rollover risk. Cutting the RRR allows for the injection of liquidity on an uncollateralized and permanent basis. But *RRR cuts are not causal to bank asset growth* and bank asset growth is what matters. And here is bank asset growth:



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As detailed in past notes, credit growth is the be all and end all of the Chinese economic data set. Just watch the TSF data – it's been clearly indicative of an absence of "stimulus" and a continued deterioration in growth prospects.

So how can China turn things around? Call it the Willie Sutton approach to economic stimulus – they need to go where the money is: infrastructure and real estate. The time-tested two-pronged formula: force credit via state-owned banks into local governments to build a bunch of infrastructure they don't really need, and ease home-purchase restrictions to facilitate the spillover of liquidity into the real estate bubble.

The obvious problem with this approach is that everyone, including the Chinese government itself, acknowledges this is an economic dead end.

Has the Chinese government actually, finally, really decided that they just can't do "borrow and build" anymore?

I doubt it. Forced investment is in China's economic DNA.

So why aren't they doing it yet? Some theories:

- To save political face, Xi wants to put as much time as possible between the next stimulus push and his ill-fated "deleveraging" pledge.

- The currency is more of a behind-the-scenes constraint than is visible. (As capital flows become a controlled variable via the use of quotas on FX supply, market indicators of exchange rate pressure have become less useful).

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- With systemic credibility dented by the trade spat, officials are concerned that a push for stimulus might not actually work

Any organic improvement in confidence would lessen the chances that a stimulus program – which we all know is a bad idea in the medium-term – might backfire by denting confidence in economic management even further. From this perspective, we're likely to see a window for Chinese stimulus in the spring. A tentative trade truce, a Fed on hold, and a stabilization of global asset markets would provide a much more propitious backdrop for an old-school stimulus push.

Yes, the Chinese economy is in dire straits. But credit stimulus is still in the holster. I'm not sure how many bullets they have left, but If we get a trade deal and the Fed signals an extended pause (a good start today from Kaplan) then expect Xi to empty the chamber come spring.

Conclusion

Accumulating evidence points to a serious economic slowdown in China. But there is little sign that they've yet attempted a credit stimulus.

Unless Jay Powell is simply intent on blowing us all up, a Fed pause and a trade truce should provide more fertile ground for credit stimulus, which we expect to be underway shortly. (FWIW, I put little stock in the narrative that the Fed is deliberately trying to blow up China with the December hike).

The end game for China's credit bubble and the RMB will come with renewed confidence in the U.S. economy which allows for a more sustained bout of trade friction and Dollar strength. That seems a story for the second half of 2019 at the soonest. Until then, a chastened Fed and topped out Dollar should allow China some breathing space for credit stimulus.