

“The China Narrative That Really Matters”

I'm a China bull, let's get that out of the way first. But like anything connected with the global industrial and commodity complex today, from Emerging Markets to MLPs to oil prices, it doesn't matter what the Truth with a capital T might be regarding the real world economic or business fundamentals. The story is broken. The stocks are broken.

I've written a lot here in Epsilon Theory about what's happening in China and what it means for the China growth story to break.

Most directly on the topic, read "[When the Story Breaks](#)". It's a quick read and introduces an Epsilon Theory perspective for how to think about China.

Most recently on the topic, and why the Chinese currency devaluation kicks US equity markets right in the teeth, read "[Storm Warning](#)".

Most fundamentally on the topic, and why the Chinese currency devaluation is an existential issue for the Beijing regime, read "[The Dude Abides: China in the Golden Age of Central Bankers](#)".

There are other notes on China if you're so inclined, including: "[The Donkey of Guizhou](#)", "[Rosebud](#)", and "[The Power of Why, Exhibit 4,512 in a Continuing Series](#)".

For a related note on the overall Emerging Market story, read "[It Was Barzini All Along](#)". For an Epsilon Theory perspective on oil prices, read "[The Unbearable Over-Determination of Oil](#)".

Now most stories heal themselves over time, and the China growth story is no exception. Or rather, over time these broken stories evolve into a market-supportive story, for example from a growth story into a value story. You see this in market narratives all the time.

But there's one aspect of the China story that can't heal itself or transform into something more benign from a market perspective, and that's the Narrative of Chinese Government Competence. To quote myself in "When the Story Breaks":

"This is a completely different Narrative than the growth story, and it's the story that one-party States rely on to prevent even the thought of a viable political opposition. In highly authoritarian one-party nations – like Saddam's Iraq or the Shah's Iran – you'll typically see the competence Narrative focused on the omnipresent secret police apparatus. In less authoritarian one-party nations – like Lee Kuan Yew's Singapore or Deng Xiaoping's China – the competence Narrative is more often based on delivering positive economic outcomes to a wide swath of citizens (not that these regimes are a slouch in the secret police department, of course). **From a political perspective, this competence Narrative is THE source of legitimacy and stability for a one-party State.** In a multi-party system, you can vote the incompetents (or far more likely, the perceived incompetents) out of office and replace them peacefully with another regime. That's not an option in a one-party State, and if the competency story breaks the result is always a very dicey and usually a violent power transition."

So when I read [an article this morning](#) in a famous media outlet owned by famously Beijing-

friendly Rupert Murdoch that "the impression left on investors is that Chinese authorities are out of their depth" and that "certainly with respect to the stock market, their reputation for incompetence is well-earned", I get nervous.

I get nervous because the next move in China is going to be a political move, and political moves are *never* well anticipated by markets. The Beijing regime is going to take steps to defend itself, or at least insulate itself, from the growing Narrative that they are incompetent. Heads will roll. Literally, in all likelihood. But the incompetence genie is very hard to stuff back into the bottle, and depending on whose head is on the chopping block, regime stability can deteriorate very quickly. Now that's what will make me change my bullish stance on China fundamentals, and that's what will make the US market swoon of last August look like a gentle spring rain.

From an Epsilon Theory perspective, a collapse in the Narrative of Chinese Government Competence is the biggest systemic risk out there right now, and that's where I'm focusing my risk antennae.

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