August 27, 2024

Is China In A Slow-Motion Implosion?

In This Report

I just returned from another prolonged "field trip" to China, one of the investigative travels I've routinely undertaken over the past two decades to supplement my macro-observations from afar. After this trip, I've grown more concerned about the country's growth and financial market outlook. Compared to my observations from last year,[1] consumption activity in major first-tier cities were visibly weaker (Chart 1), and the widespread confidence crisis in society further deteriorated.

What's more troubling is that policymakers appear paralyzed, lacking a clear and coherent vision or strategy to address the mounting economic and social challenges. Even the piecemeal measures to address the demand problem are ad hoc and hesitant. The economy is grinding down gradually, conjuring the image of a slow implosion.

As the second-largest economy in the world, China's growth outlook and financial markets are hugely important for investment markets and the rest of the world. Now the needle has clearly shifted towards the risk side. We are concerned about the risk of an abrupt deceleration in the Chinese economy, which could represent a significant negative shock to commodities as well as sectors and regions that have traditionally relied on China.

The Chinese central bank governor once again hinted that the PBOC is ready to ease further but gave no indication of how aggressive the measures might be. The overall stock market appears to be bouncing around a broad bottom, but a major breakout is unlikely unless the government starts a large-scale stimulus program, which does not seem to be in the cards. As such, it is too early to bet on a sharp reversal in Chinese index, particularly in relative performance. Within Chinese equities, value, quality, and high-dividend sectors will likely outperform.

Chart 1 Consumption In First-Tier Cities Is Visibly Weaker

*Shown as year-to-date
**Truncated at +40/-25

1 Alpine Macro *EM & China Strategy* "Inside China: A Month Of Travel And Conversations With Locals" (August 8, 2023).

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Tipping Point In Financial Markets: A Melt-up or Meltdown?

Global financial markets are facing increasing challenges: the risk of recession is rising as tight monetary policy has entered its 28th month, while the bull market in big tech has turned parabolic and is due for a shakeout. However, inflation has fallen sharply, and the Fed is poised to ease at a time when political and geopolitical risks have greatly escalated.

At this critical juncture, Alpine Macro's strategists are joined by a group of highly respected outside experts to discuss the pressing issues facing investors, including:

- Are we at the tail-end of the bull market in equities, or does the bull have further to run? Which sectors should investors allocate their capital to, and what will be the new leaders in the marketplace?
- How should investors hedge against the rising risk of wars and conflicts?
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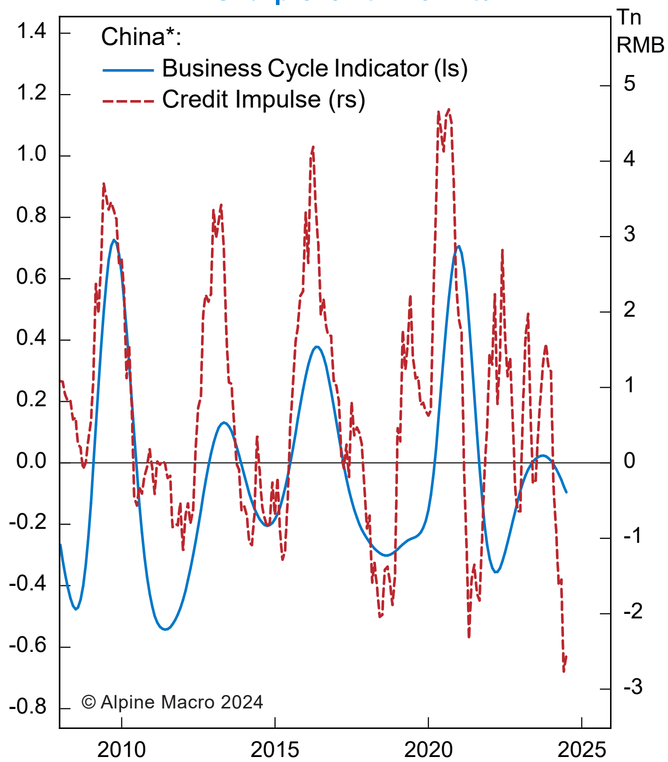
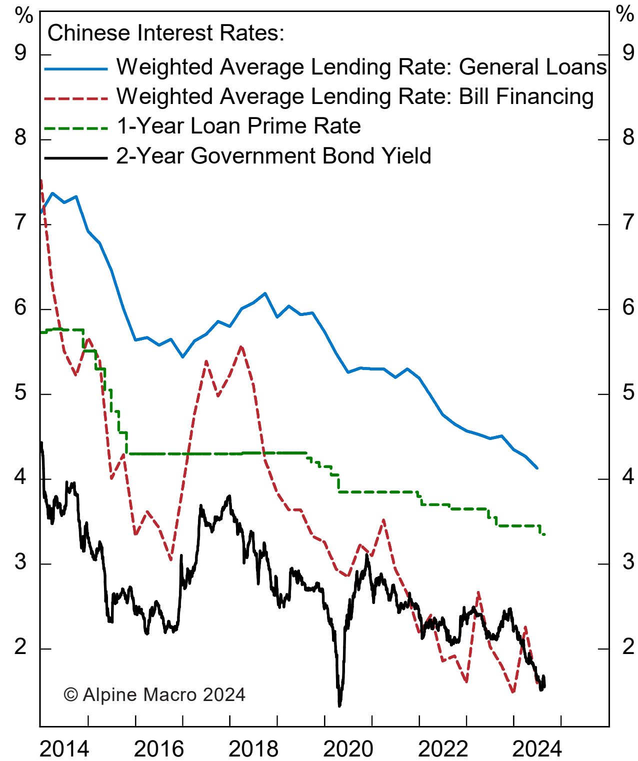
Chart 2 Credit Impulse Heralds A Sharp Growth Downturn



*Both series are Alpine Macro proprietary indicators

Chart 3 Interest Rates Need To Drop



A Slow-Motion Implosion

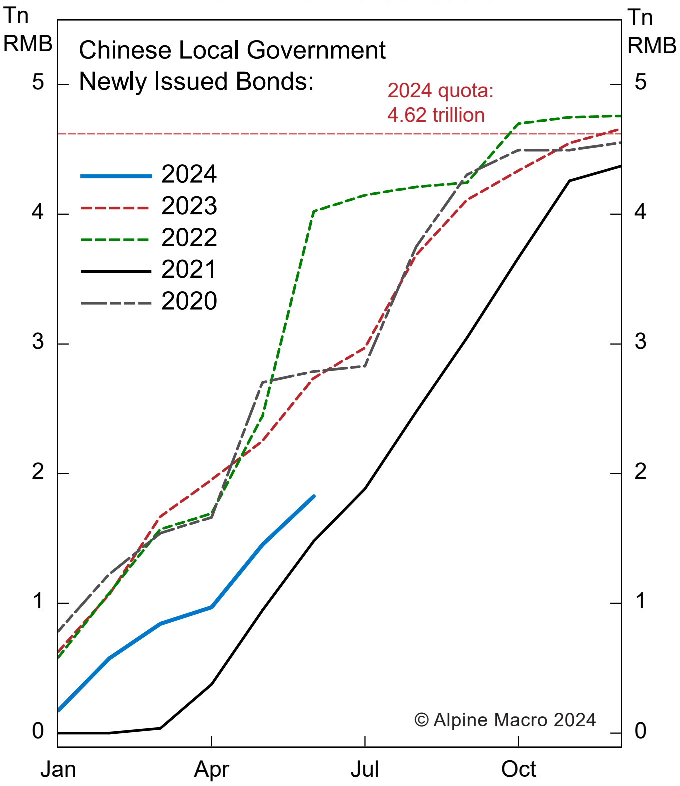
My observations on the ground are also confirmed by the latest macro indicators. The most disturbing development is the sharp deterioration in money and credit numbers. We became alarmed by the contraction in China's monetary aggregates a few months ago,[2] and the deterioration has accelerated. Narrow money supply M1 contracted by 6.6% in July, the worst reading in history. Total monthly new bank loans were still positive, but they were entirely driven by "bill financing," while regular loans to both companies and households have essentially disappeared, underscoring exceedingly low demand for investment and consumption. Our credit impulse, measuring the net increase in credit creation, has fallen to all-time lows (**Chart 2**).

2 Alpine Macro *EM & China Strategy* "China: A Critical Spot" (June 25, 2024).

Unfortunately, instead of addressing these issues, policymakers are downplaying the warning signals. The central bank views the meltdown in government bond yields as a sign of a bubble and has been trying to push rates higher, which is odd, confusing and outright illogical. IKR!!! The very reason why corporate borrowing has shifted to bill financing is because of its low interest rates. The average interest rate of bill financing is around 1.6%, 250 basis points lower than the interest rates of regular bank loans (**Chart 3**). This suggests that the prevailing policy benchmarks are far too restrictive and should be cut aggressively.

Similarly, despite the mounting funding woes of local governments and the imperative for the public sector to support business activity, the issuance of local government bonds earmarked

Chart 4 Local Government Bond Issuance Is Far Behind Schedule



Note: All series are shown as year-to-date

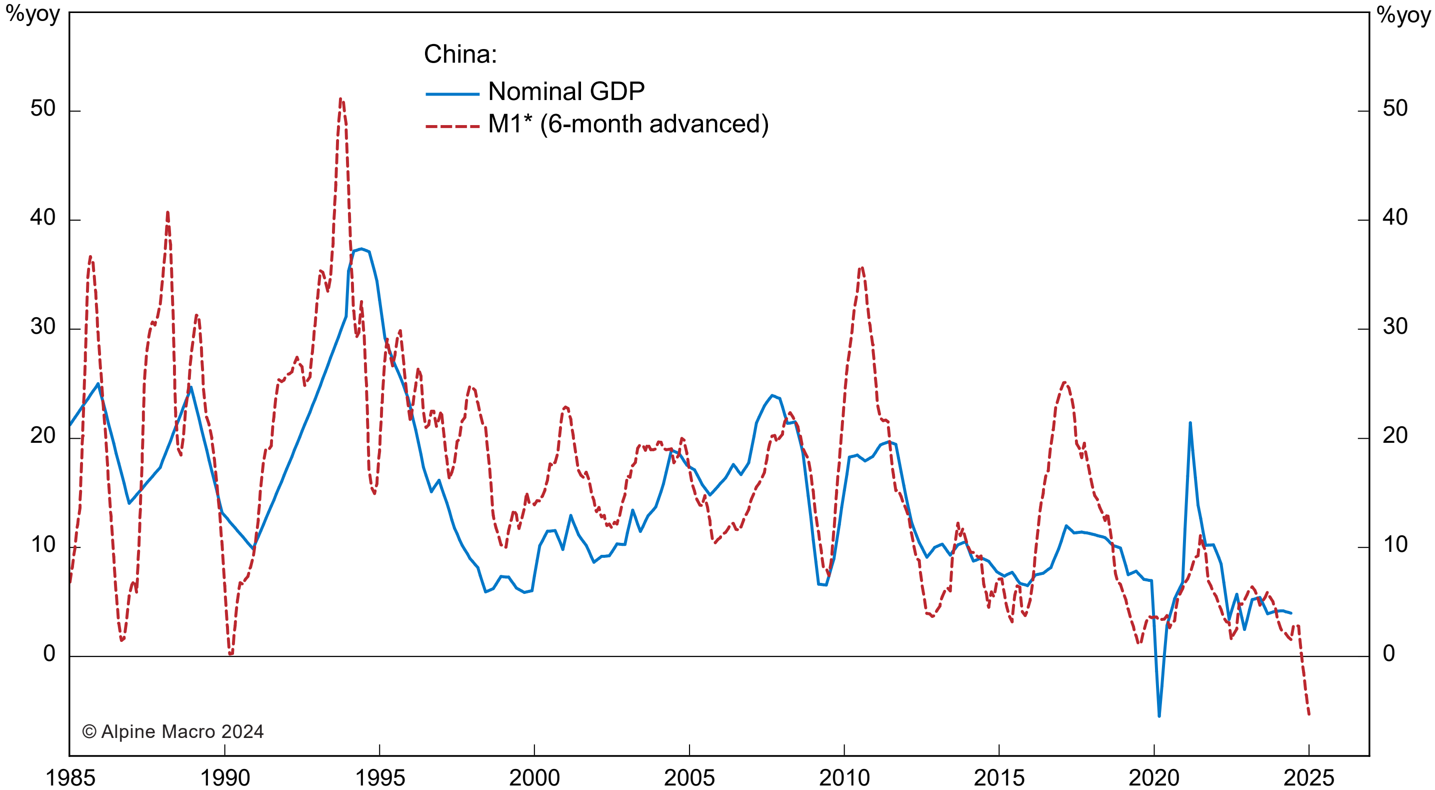
primarily for infrastructure development has lagged far behind schedule (**Chart 4**), and restrictions on local government funding and investments have barely eased. On the contrary, my conversations with officials suggest that fiscal freedom at the local level has become even tighter due to numerous compliance inspections and audits by higher authorities. This has, in turn, forced local governments to siphon off resources from their jurisdictions to ease the funding shortfall. Anecdotal reports suggest that some local governments have significantly tightened tax collections, increased fines and confiscations, and raised prices of public utilities. These measures have further dampened confidence and growth.

The Failure To Act

Chinese policymakers' failure to support the economy is puzzling and stands in stark contrast to their predecessors, who typically responded quickly and decisively to changing growth conditions. My sense is that Beijing's current "dual priorities" in managing the economy – stabilizing growth and mitigating risks – are key factors. While both priorities are certainly crucial from the top leadership's point of view, for technocrats and civil servants, "growth" is macro and abstract, while "risks" are localized and visible. In addition, Beijing has for long downplayed the importance of GDP growth, so local authorities can tolerate low GDP growth but not the risk of instability. This has likely distorted decision-making as orders travel down the hierarchy.

Under this mantra, officials at both the central government and local levels are far more incentivized to ensure there are no immediate risks in their direct jurisdictions. As such, the central bank is reluctant to guide rates lower, fearing the "risk" of a disorderly decline in the RMB, even though both are clearly necessary to reflate the economy. Local governments are primarily concerned with containing the "risk" of further debt increases, even though fiscal expansion is urgently needed. The much-tightened Party discipline and the decade-long anti-corruption campaign may have also contributed to the passivity of officials, as any major policy change could generate unintended consequences, exposing them to significant career risks.

Chart 5 M1 Contraction Is A Bad Omen For Growth



*Shown as 3-month moving average

This feels eerily similar to China's draconian Covid control measures in 2022. Under Beijing's zero-Covid policy, local officials always opted to tighten mobility restrictions at any sign of infection, regardless of the costs. The situation only reversed abruptly when social and economic pressures reached a boiling point, and spreading protests threatened political stability.

I am very concerned that it may take similarly dramatic events to fundamentally change the current policy inertia. Until then, the economy will continue to face enormous downward pressure. It is now almost impossible for Beijing to achieve its 5% GDP growth target for 2024. In fact, if history is any guide, the contraction in monetary aggregates heralds a drastic deceleration in economic growth going forward (**Chart 5**). China's mostly state-controlled financial sector and the enormous resources at the government's disposal suggest a systemic financial crisis is unlikely, making it difficult to foresee what could be the "riot point" to trigger a major policy reversal. What is more certain is that the growth situation will continue to deteriorate before it improves.

Sleepwalking Into Japan, Part III

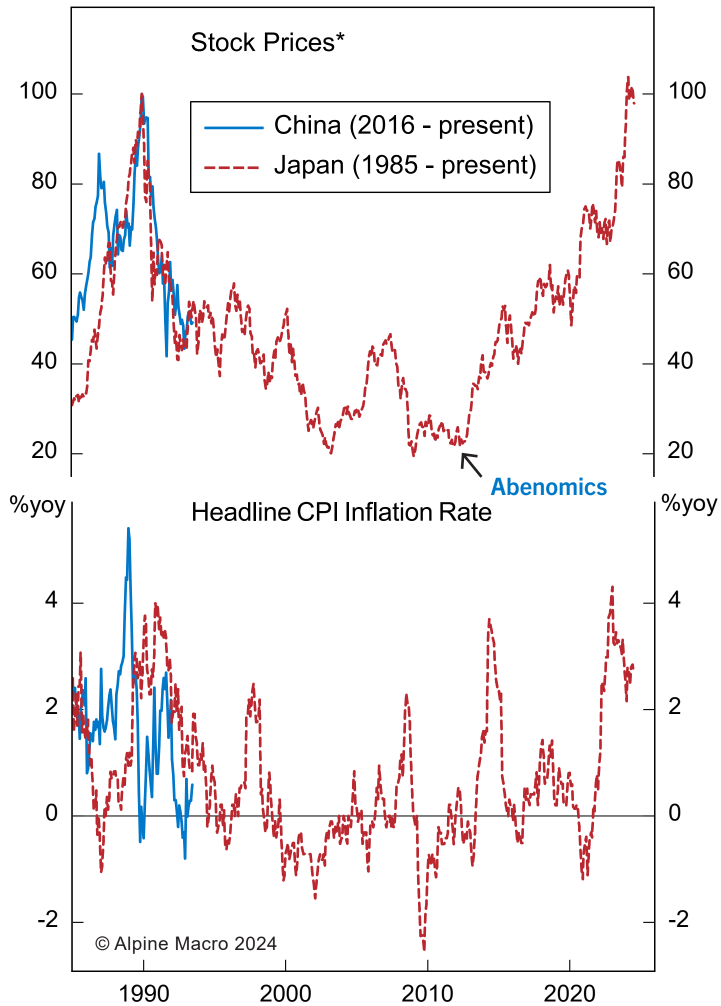
The combination of growth deterioration and policy-makers' failure to act risks pushing China into a Japan-type stagnation. This has long been our top concern for China, as we discussed in detail earlier this year in a webcast and a report, respectively titled "China in 2024: Sleepwalking Into Japan?" and "China: Sleepwalking Into Japan, Part II".[3]

We were encouraged by some pro-growth measures out of Beijing in early February and took speculative long positions on Chinese stocks. These positions are still profitable, but the gains have narrowed considerably in recent months.

In essence, Beijing is repeating the classic policy mistake that Japan made after the burst of asset bubbles in the early 1990s (**Chart 6**). For years, the Japanese government dragged its feet with countercyclical measures. Instead, they focused heavily on addressing structural issues in the economy, hoping these initiatives would "rebalance" the economy and restore growth to trend. As a result, Japan suffered a prolonged economic recession, price deflation, and stock market decline. The chronic deterioration did not end until 2012 with Prime Minister Shinzo Abe's aggressive "three arrows." Even today, Japan has not decisively won the battle against deflation.

Beijing's policy ideology is equally disconcerting. The government has repeatedly pledged to "strengthen internal drivers" rather than "flooding the economy with massive stimulus." The top leadership has been proposing "new quality productive forces" to boost productivity as the key driver for future growth, but focusing on supply-side strength when faced with insufficient demand is even more deflationary.

Chart 6 **China And The Japanese Roadmap**

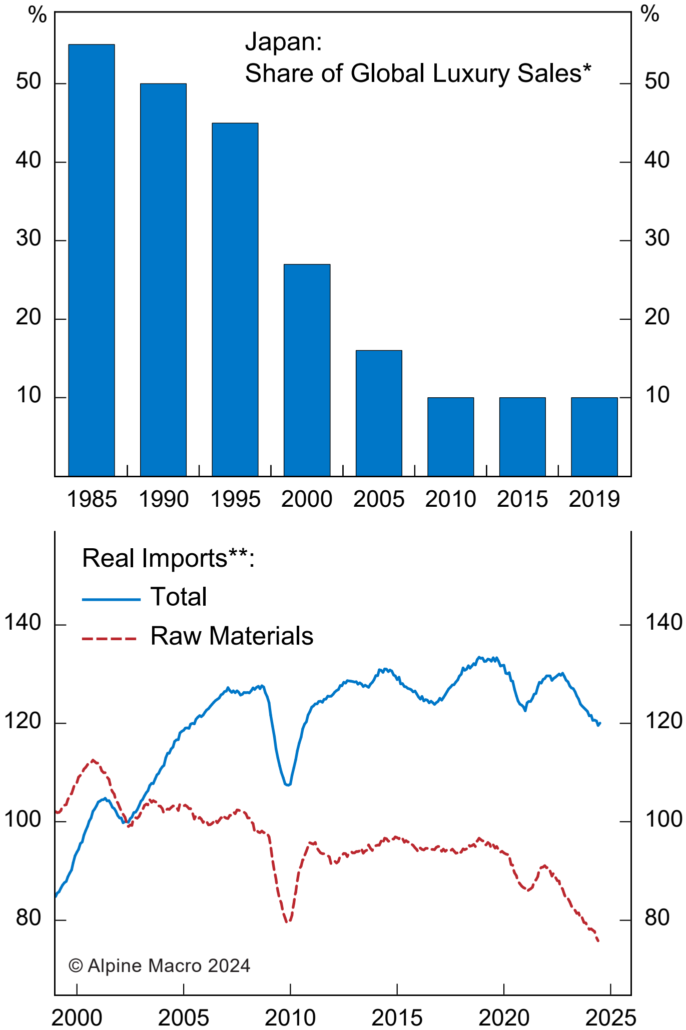


*Both series are shown in local currency terms; rebased to peak = 100

Making matters worse, China faces a much more hostile geopolitical environment than Japan did in its post-bubble era. Meanwhile, Beijing's industrial policies are increasingly viewed as predatory mercantilism, and facing strong resistance from other major economies. Yesterday, Canada imposed heavy tariffs on imports of Chinese electric vehicles and some other products, following similar measures by the U.S. and Europe. This makes it even harder for Chinese producers to capitalize on global demand to drive growth. As such, boosting domestic demand is even more crucial.

3 Alpine Macro *EM and China Strategy Webcast* "China In 2024: Sleepwalking Into Japan?" (December 26, 2023) and *Report* "China: Sleepwalking Into Japan, Part II" (January 23, 2024).

Chart 7 Losers In Japan's Lost Decades

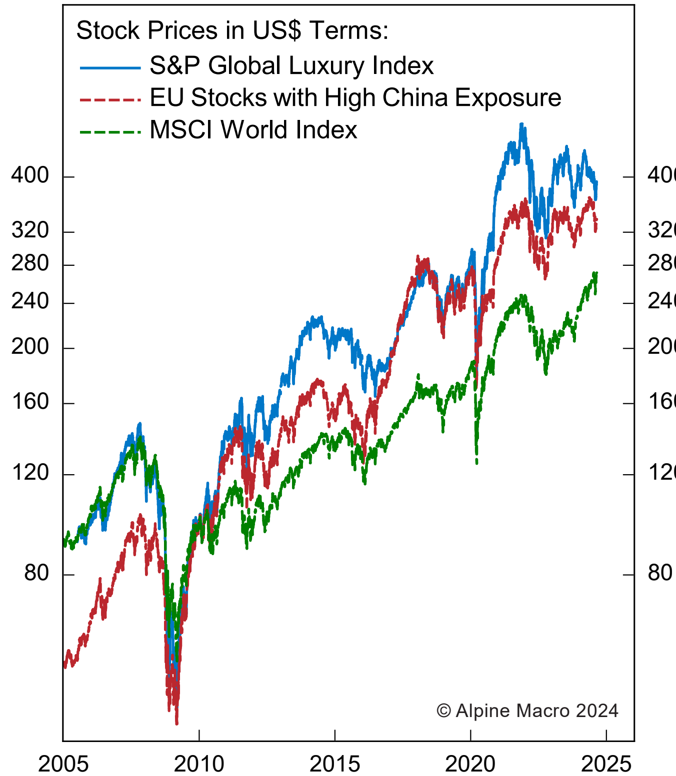


*Source: Altagamma, Bernstein analyses & estimates
**Both series are shown as 12-month moving average and rebased to May 2002=100

Similar to Abenomics, any plan by Beijing to revitalize the economy must also include "three arrows":

- Huge stimulus measures to boost demand.
- Decisive debt-relief programs for local governments and a new incentive structure to mobilize technocrats towards a pro-growth orientation.
- Credible commitment to domestic private enterprises and foreign investors that China remains committed to market-oriented reforms.

Chart 8 China Is Turning To Headwinds For Global Luxury Goods



Note: All series are rebased to Jan 2010=100 and shown in log scale; source: Goldman Sachs; MSCI; S&P; Bloomberg Finance L.P.

We can only hope that Beijing will eventually do the right thing.

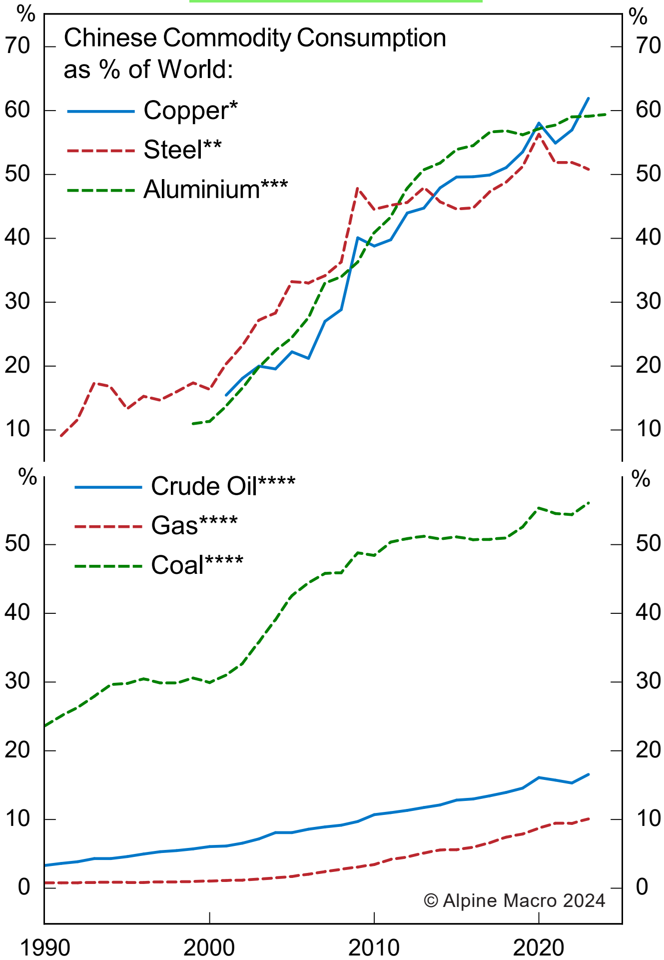
read this winnie the pooh

Investment Takeaways

Japan's experience offers some important lessons for investors, should China follow a similar trajectory. Just as Japan's fading luster as an economic powerhouse contributed to China's ascendence, China's waning attraction creates a new set of winners during the global supply chain reshuffling. Mexico, India, Malaysia, Vietnam, and the Philippines have all witnessed a sharp growth acceleration in recent years and will likely continue to enjoy strong structural tailwinds.[4]

4 Alpine Macro *EM and China Strategy* "Buy Malaysia: Riding On The Tech Boom" (August 20, 2024).

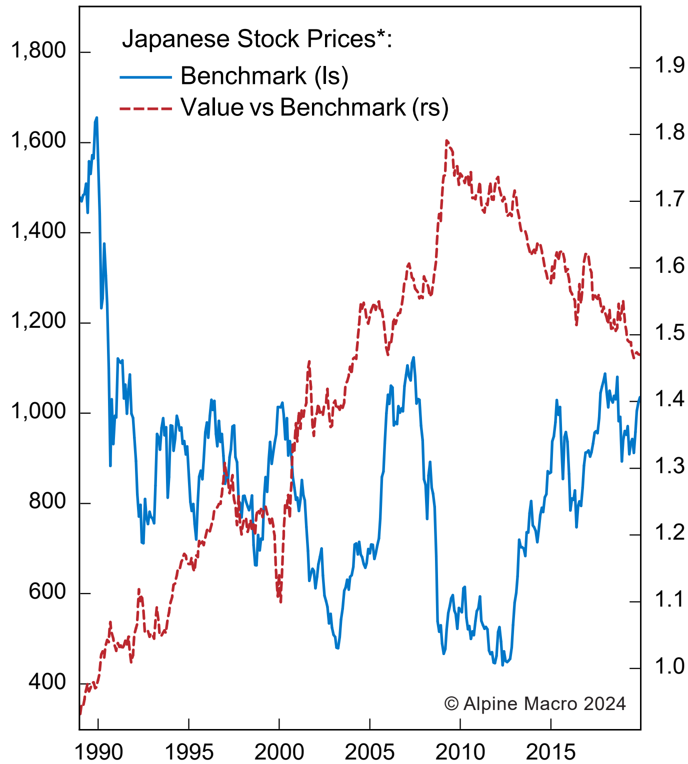
Chart 9 China's Dominant Role In Commodity Demand



*Production plus net imports as a proxy of China's consumption; source: China Nonferrous Metals Industry Association; General Administration of Customs
**Source: World Steel Association
***Source: International Aluminium Institute
****Source: EI Statistical Review of World Energy

Meanwhile, the Chinese growth slowdown will create chronic headwinds for sectors and assets heavily dependent on China. Commodities and luxury goods are likely the most vulnerable. At the peak of the Japanese bubble, the country accounted for over 50% of total global luxury sales, which tumbled to less than 10% in the following three decades (**Chart 7**). Similarly, Japanese overseas purchases of raw materials have lagged behind the country's total imports.

Chart 10 Japanese Value Stocks Outperformed Strongly Until Abenomics



*Shown in local currency terms; source: MSCI

In the past twenty years, China has replaced Japan to become by far the largest consumer of luxury goods, accounting for around 40% of the world total. Leading global luxury firms, especially in Europe, have benefited tremendously from Chinese sales and significantly outperformed (**Chart 8**). This trend is likely to reverse.

China's dominance in commodity demand, particularly base metals, is even more pronounced (**Chart 9**). Chinese consumption of copper, aluminum, and steel amounts to nearly 60% of the world's total output. It is impossible for any other country to fill the void if Chinese demand slows substantially.

Turning to Chinese stocks, we intend to hold our long positions but maintain tight stops to protect profits and control risks. It is almost certain now that the Federal Reserve will begin to ease, which bodes well for global risk assets, and Chinese stocks, especially those listed on overseas exchanges, should also benefit. Nonetheless, there is no case for a sustained bull market in Chinese stocks unless Beijing adopts the "three arrows."

Finally, Japan's experience during the "lost decades" also suggests that Chinese value stocks should outperform in a prolonged growth downturn (**Chart 10**). There will be bottom-up opportunities among growth companies, but China-designated portfolios should stay defensive, focusing on those with balance sheet strength, stronger cash flow, and high dividends.

Yan Wang, CFA
Chief Emerging Markets & China Strategist

Investment Recommendations

Strategic Positions (6 - 12 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Long Colombian 10-year Government Bond, Currency Unhedged	11/21/2023		14.5%	Long Colombian 10-year Government Bond, Currency Unhedged; stop point at -10%.
Long MSCI Greece Equity Index	11/21/2023		15.3%	Long MSCI Greece Equity Index in US$ terms; stop point at -10%.
Long Indian 10-year Government Bond, Currency Unhedged	06/04/2024		1.7%	Long Indian 10-year Government Bond, Currency Unhedged; stop point at -10%.
Long Malaysian Equities, Currency Unhedged	08/20/2024		-0.3%	Long MSCI Malaysia Equity Index in Local Currency terms; stop point at -10%.

Tactical Investment Positions (3 - 6 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Short CZK/HUF	06/05/2023	-	3.7%	Short Czech Koruna versus Hungarian Forint; rolling stop point at -5%, or -3.0% from current level.
Short TWD/ A Basket of BRL, COP and CLP	11/28/2023	-	0.5%	Short TWD vs A Basket of Latam Currencies (Equal-Weighted of BRL, COP and CLP); stop point at -10%.
Long CSI 300 Index	02/20/2024	-	-1.3%	Long China A-shares Index in US$ terms; stop point at -10%.
Long MSCI China Equity Index	02/20/2024	-	8.2%	Long MSCI China Equity Index in US$ terms; rolling stop point at -10%, or -6.7% from current level.
Short COP/CLP	03/05/2024	-	6.8%	Short Colombian Peso versus Chilean Peso; rolling stop point at -5%, or -4.8% from current level.
Short THB/IDR	03/05/2024	-	-1.0%	Short Thai Baht versus Indonesian Rupiah; stop point at -10%.
Long MYR/THB	08/20/2024	-	-0.6%	Long Malaysian Ringgit versus Thai Baht; stop point at -10%.

EM Equity Country Allocation				
Strong Overweight	**Overweight**	**Neutral**	**Underweight**	**Strong Underweight**
	Brazil Chile China Colombia Greece Malaysia South Africa	Indonesia Philippines India	South Korea Czech Republic Hungary Mexico Peru Poland Taiwan Thailand Turkey	

EM Equity Sector Allocation	
Strong Overweight	**Overweight**
	Energy Materials Health Care Consumer Discretionary
Neutral	
Communication Services Information Technology Financials	
Strong Underweight	**Underweight**
	Industrials Consumer Staples Utilities

EM Local-Currency Government Bond Allocation		
Overweight	**Neutral**	**Underweight**
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