China Appears to Be Losing the Trade War

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The current trade dispute with China goes to the heart of the Chinese economic model and President Xi's perception of China's place within the global power structure, in my view. That means the current trade war could extend for many years. Setting investment strategy during an extended trade war requires an understanding of how this dispute is impacting the Chinese economy and, through China, global financial markets. With that in mind, I have just returned from an extended due diligence trip to Asia. The trip included stops in Hong Kong, Taipei, Shanghai and Tokyo, and I met with leaders across a broad range of industries.

The tone of my recent meetings differed sharply from prior trips to Asia. In previous trips over the past 10-years, I have always encountered a chorus of very bullish opinions on China, a few very bearish opinions, with most business leaders expressing cautious optimism. On this trip, nearly everyone expressed concerns about short term growth prospects in China. The most optimistic voices I heard expect a temporary lull in Chinese growth, while the most pessimistic anticipate their long expected collapse of the China bubble.

The broader implication of these gloomy assessments is that China is currently losing the trade war with the U.S.. President Trump's aggressive trade war tactics have forced a reevaluation of corporate strategy regarding total reliance upon Chinese product production. Companies have woken up to the possibility that access to goods made in China can be cut off at the stroke of a Presidential pen. They are reacting to this newly perceived risk by diversifying their product manufacturing plans away from complete dependence upon China. Private investment spending in China is falling rapidly as a result, in my view.

The U.S. economy should be largely immune from a China slowdown because our nearly $400 billion trade deficit makes China a net drag on U.S. final demand. However, investors should be prepared for China's trade war retaliation tactics and the potential impact on U.S. financial markets. Based on my contacts in China, China's most likely retaliation strategy is to sell some portion of their U.S. government bond holdings. Proceeds from these sales could then fund large scale intervention in Chinese equity markets, creating upward pressure on U.S. interest rates while also potentially stabilizing China's equity and currency markets.

If such intervention occurs, oversold conditions in emerging market equities could lead to a meaningful short-term rally. Longer term, China's economic model remains anchored to the Asian Development Model concepts pioneered by Japan after World War II. Consistent with Japan's experience, China's growth is becoming ever more dependent upon real estate investment. Beijing's policies are now laser focused on maintaining lofty valuations in their real estate markets, and this should allow China to avoid a destabilizing recession for the time being. However, absent reform, China appears poised eventually to follow Japan's path into secular stagnation. Emerging economies dependent upon Chinese demand for their raw materials or investment in "One Belt One Road" infrastructure projects could slow along with China.

COMPANIES NO LONGER SEE CHINA AS "THE WORLD'S FACTORY":

The trade dispute with the Trump administration has revealed the risks involved in sourcing all product production in a single country, especially if that country is as geopolitically provocative as China. Foreign companies and even some domestic Chinese producers are looking to move their export production capacity outside of China as quickly as possible. The concept that China could serve as the world's factory is not merely being called into question, it is now being dismissed as far too risky in a world in which access to Chinese production can suddenly be subject to prohibitive tariffs or outright embargo. This change in corporate strategy has effectively frozen private sector investment spending in China.

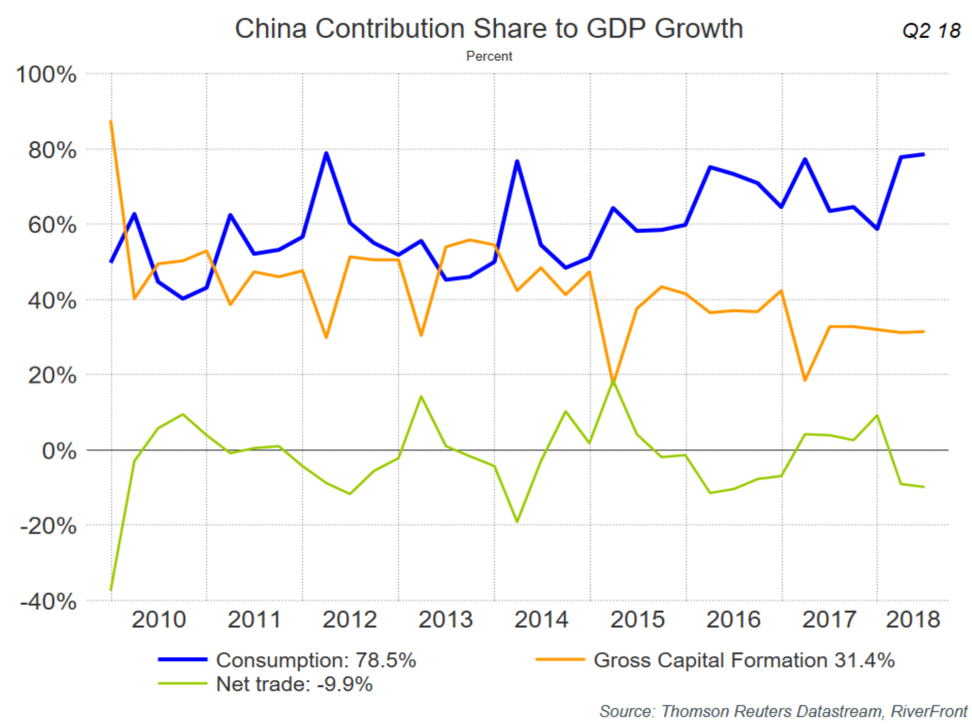
Companies operating in China will retain significant operations there to address rapidly growing domestic Chinese demand and regional export markets. However, moving significant export capacity to other markets will create excess capacity problems in even more Chinese industries. Excess capacity in a wider array of industries could depress private investment spending for many years to come. This slowing in investment spending could exacerbate a potential slowdown in One Belt One Road ("OBOR") infrastructure expenditures. Several existing OBOR projects have run into financial difficulty. China has responded by assuming control over these facilities, and their high-handed behavior has eroded local support for these projects in several countries. Traveling in China with a Mandarin speaker (my daughter) left me with an impression that OBOR is also increasingly unpopular in China. As the Chinese economy slows, more Chinese people appear to be concluding that money would be better spent at home.

The movement of production out of China will create some winners in select emerging markets. Taiwan is likely to benefit from "reshoring" technical processes that have been recently offshored to China. Less sophisticated production processes are expected to be relocated to Southeast Asia, especially Vietnam and India. Over the long run, sophisticated processes are expected to be relocated to Eastern Europe. These countries offer relatively low labor costs and a highly educated workforce with the skills to handle sophisticated production technologies. Based on my limited sample of business leaders, relocation to the U.S. or Mexico does not seem to be very high on anyone's list.

THE BULLISH CASE FOR CHINA: CONSUMERS AND REAL ESTATE:

An undeniable success story for the Xi government over the past few years is the rebalancing of the Chinese economy away from an overdependence on investment and infrastructure spending and toward consumption. As overall growth slowed in recent years, consumption growth has remained a steady 4% contributor to growth (at least according to Chinese economic statistics). That means consumption is now approaching 80% of overall GDP growth compared to less than 50% for much of the past decade, providing a much healthier and sustainable growth profile for the Chinese economy.

The bulls say this consumption growth will continue and form the base upon which the Chinese economy will rebound, after adjusting to the relocation of export capacity and other short-term headwinds to growth. The bears think that consumer confidence and consumption growth will slow when Chinese consumers encounter their first tough economic environment. They point to the current sharp slowdown in auto sales as the canary in the coal mine regarding the underlying attitude of Chinese consumers. Bears also believe the large social security tax increase taking effect this month will create further headwinds for consumers.



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Whether China bull or China bear, everyone I spoke to agrees that real estate is the linchpin to the Chinese economy. Real estate is more important than the trade war, the relocation of production capacity or OBOR. Upper- and middle-class Chinese consumers are heavily exposed to real estate. If the value of their real estate portfolios keeps climbing, the bulls believe these consumers will keep spending and keep driving the Chinese economy higher.

The problem with this real estate dependence is that Chinese real estate markets defy any traditional valuation rationale. For example, one of my contacts just relocated from the U.S. and explored buying the home he is currently renting. Based on the property's current market value, the owner of that home is renting the property at -5.6% annual loss. To achieve a 0% return the rent would have to increase 260%. Achieving the 4% return typically offered on Chinese bank CDs would require a 450% rent increase (and these figures assume no operating or maintenance costs).

Rents are very low relative to prices, yet the much anticipated crash in the China real estate bubble never seems to occur. Even prices in second and third tier cities have bounced back from the staggering oversupply RiverFront documented a few years ago. The most compelling explanation I received for persistently overvalued Chinese real estate markets is that prices are high because the government needs them to be high. Local governments must sell property to generate revenue (Communist party officials own billions in real estate and have never allowed local governments to impose property taxes). The national government in Beijing must deliver growth to legitimize their increasingly autocratic rule, and high real estate prices are necessary to keep construction spending and therefore economic growth high. All levels of government need high real estate prices and therefore every lever of government power, from regulations to lending standards to central bank interest rate policy, is applied to maintaining healthy property markets.

As shown in the below chart, Chinese real estate markets go through periodic cycles of price acceleration and deceleration based upon policy stimulus applied by Beijing. As the trade war started to impact overall economic growth, Beijing quickly introduced stimulus measures that have caused a recent surge in real estate pricing (green circle). Regulatory policy requires most real estate purchases to be largely financed by equity down payments rather than mortgage debt. That means the large gap between real estate prices and rent levels doesn't act as a brake on overall real estate prices because most buyers do not have to make a mortgage payment. Equity financing of real estate purchases also helps support prices by preventing the downward price spiral that can occur when mortgage foreclosures cause real estate liquidations, which cause further price declines, which cause further foreclosures, etc. Chinese investors keep buying real estate despite high prices and low cash flow returns because they have few investment alternatives, thanks to capital controls and very volatile equity markets.

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Historically, real estate bubbles have tended to pop because central bankers and regulators become alarmed at real estate prices and use interest rates and regulations to pop the bubble (e.g. Japan in 1990/1991 and the U.S. in 2005/2006). China is conducting an unprecedented economic experiment – if policy makers remain consistently dedicated to ever increasing real estate prices, can a bubble be maintained indefinitely? Although I suspect that these tactics merely extend the bubble and make the ultimate collapse more painful, Beijing's current barrage of policy measures designed to support real estate prices suggest the day of reckoning is still far in the future. Assuming Chinese real estate markets remain on their current upward trajectory, economic growth will slow because of the trade war but will not collapse as is currently predicted by China bears.

BEWARE THE POTENTIAL FOR RETALIATION:

Frustration with Beijing and its ineffective response to President Trump's trade policy was a consistent if carefully expressed theme in my Shanghai meetings. Xi is under increasing pressure to show that China has some leverage in its dispute with Washington. My Chinese contacts were skeptical that Beijing would openly retaliate against U.S. firms, either by restricting exports of key production components (e.g. rare earth elements, memory chips) or by blocking their ability to sell into Chinese markets. Such retaliation could simply accelerate the exodus of production capacity out of China and further crimp private investment spending.

Instead, the consensus view from my meetings is that the Chinese government will retaliate against President Trump's tariffs by liquidating some of their U.S. government bond holdings and redeploying the proceeds into Chinese equities. This might allow Beijing to pressure Washington by raising U.S. interest rates while simultaneously taking pressure off Beijing by supporting their currency and equity markets (killing three birds with one stone).

INVESTMENT IMPLICATIONS:

Short term, the investment decision on China is as simple as deciding whether you think the Chinese government will retaliate against U.S. tariff's by selling U.S. government bonds to fund Chinese equity market purchases. If that is China's response to the escalating trade war (and I believe it is likely to be), then investors should underweight bonds and shorten portfolio duration. Emerging market stocks, and especially China A-shares, have the potential to rally in response to Chinese equity market intervention (in Chinese, "don't fight the Fed" translates into "don't fight Beijing").

Longer term, I believe China's economy remains trapped in the Asian Development Model (ADM). Under ADM, export dependent growth transitions to real estate dependent growth until the bubble collapses and stagnation sets in (per the Japanese experience). Like Japan in the 1990s, the Chinese government has encountered massive political resistance to true economic reform and a move away from ADM. However, Beijing's single-minded determination to keep the real estate bubble rising stands in stark contrast to the deliberate bubble popping done by the Bank of Japan in the early 1990s. That means China's real estate markets could keep rising and their economy avoid stagnation much longer than the Japanese experience.

With respect to the rest of emerging markets, emerging Asia and Eastern Europe are likely beneficiaries of the move away from exclusive Chinese product production. Commodity dependent economies in Latin America have problems that extend well beyond China's growth prospects, but for the time being are likely to be supported by continuation of the China real estate bubble. These economies will be especially vulnerable if and when that party comes to an end.

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Index Definitions:

The MSCI China Index captures large and mid cap representation across China H shares, B shares, Red chips, P chips and foreign listings.

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