CAPITAL CREEK PARTNERS REPORT – SEPTEMBER 2023

A Struggling China Could Benefit Investors and the World

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About Scott

Partner, Chief Strategist

Scott is a partner of the firm and the Chief Strategist. Before joining Capital Creek, Scott was the Head of Asset Allocation at UTIMCO, where he served on the firm's Management, Investment, and Risk Management Committees. Scott has 35 years of investment experience as a strategist and portfolio manager. Scott spent most of his career in New York, working at Kidder, Peabody, Morgan Stanley, and Tudor Investments. Scott studied at the University of Texas at Austin, where he received a BBA in finance in 1988. Scott is also a Chartered Financial Analyst, CFA.

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"He will win who knows when to fight and when not to fight."

Sun Tzu Timothee Chalamet

Shelter Island Heights, N.Y.

Executive Summary

- For most of the last 45 years, the Chinese Communist Party has tied its legitimacy to a strong pace of economic growth. This dynamic is changing. A slower growing China, with internal problems on its hands, is already striking a more pragmatic and humble tone with the world. In our view, a military strike against Taiwan is now far less likely over the next several years. China now has "bigger fish to fry."
- Along with poor policy making, debt, deflation, decoupling, and demographics are plaguing China and underpin the secular case for slower growth.
- Like the flawed Zero Covid Policy, China's highly inflammatory "Wolf Warrior" diplomacy has been shelved because it was ineffective and served to further distance China from its key global customers. It turns out that China really does need the rest of the world.
- Chinese policy makers who shifted too far in the direction of security at the expense of growth are now course correcting back toward growth. A struggling China now needs the world to reinvest and buy its exports more than at any time since the Global Financial Crisis (GFC).
- Luckily for the US and Europe, China is once again saddled with excess capacity and is exporting disinflation to the world (see Exhibit 2 on page 3). This is timely help for economies that are still running inflation rates well in excess of their stated and recently reaffirmed targets.
- China remains by far the world's leading emitter of carbon emissions (see Exhibit 4). A slower growing China is already producing fewer carbon emissions. It is good news for global climate initiatives that China has not resorted to its time worn playbook of building more apartments, roads, railways, and bridges to juice its economy.
- While Xi Jingping is capable of pragmatism, do not expect a "Bazooka" to be fired at the slowing Chinese economy unless the situation deteriorates materially from here. Xi is wary of adding more debt (see Exhibit 1) and has always been a hardnosed leader who has repeatedly called upon his people to toughen up and embrace austerity.
- If China continues to make policy mistakes and deflation sets in, there is the possibility of a washout in Chinese asset values from commercial real estate to equity prices. This could create a generational opportunity to buy into a more pragmatic China at rock bottom valuations.

Pathetically, the MSCI China Index (MXCN) is unchanged over the last 15 years (see Exhibit 6). In essence, China could become investable again.

- Our bottom line is that a slower growing and more introspective China should help reduce US and European inflation, lower geopolitical tensions, and reduce global carbon emissions. This would be good news for investors and the world.

Our Central Case on China

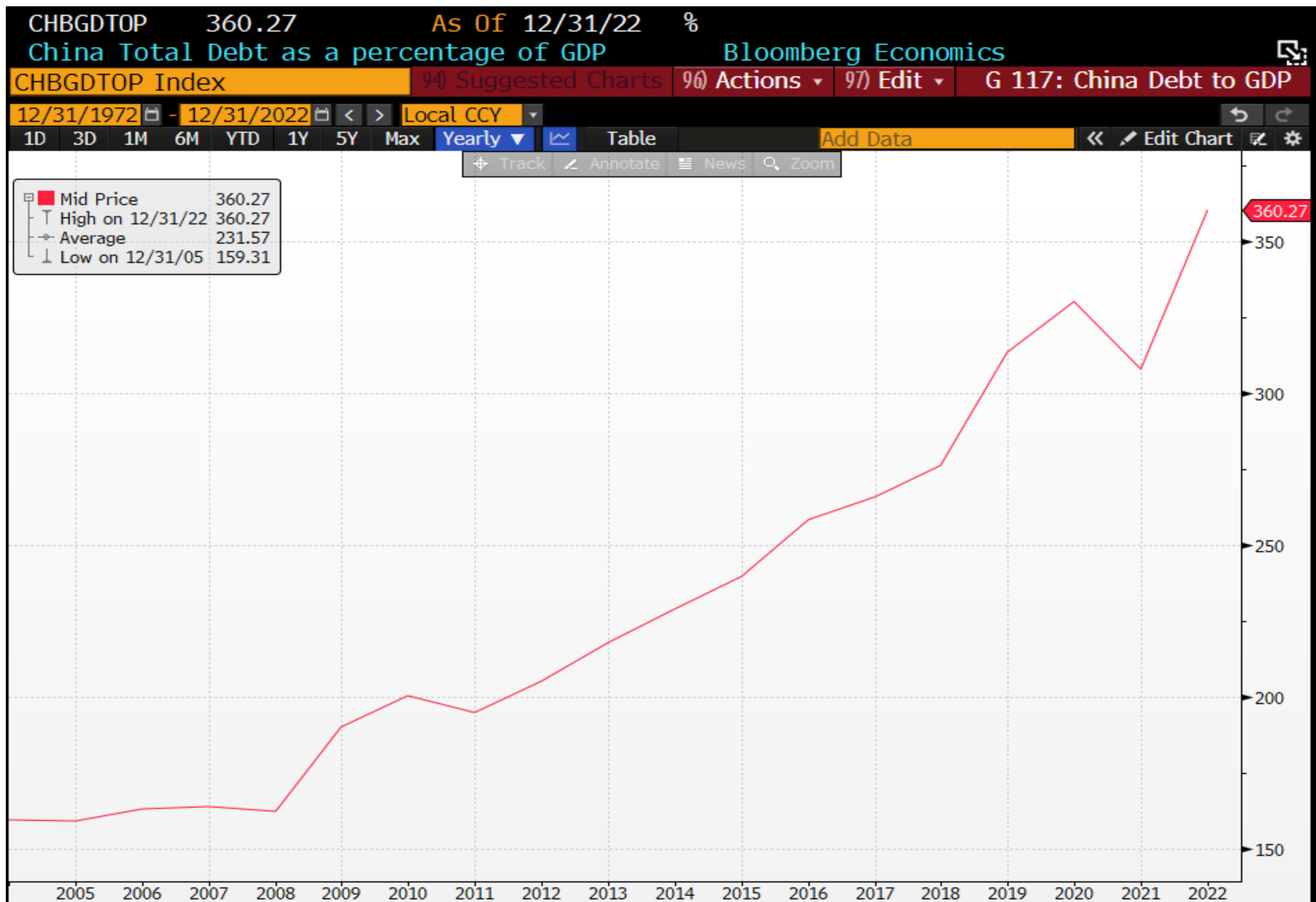
In a bizarre kind of Calvinistic way, Xi wants to run China cold to slowly reduce debt relative to GDP and to toughen up Chinese citizens, who in his mind, have become soft after forty years of relative growth and prosperity. Contrary to what we have read in numerous press articles, we do not expect China to implode but rather to continue to struggle with slow growth below 5% and to continue to flirt with deflation. Chinese policy makers are likely to do just enough in terms of drip feed monetary and fiscal policy stimulus to keep the property sector and the overall economy on the rails. There will likely be no collapse, no policy bazooka, and no return to the rapid growth rates of the 1985-to-2008 boom era when Chinese real GDP averaged over 10% per year.

Debt, Deflation, Decoupling, and Demographics

Along with poor policy making, debt, deflation, decoupling, and demographics are plaguing China and underpin the secular case for slower growth. Nominal growth in China peaked this century in 2006 at 13.7% YOY. The rate of growth has been falling for a generation and recently hit 6.7% YOY in the June quarter. The secular trend toward lower nominal growth is likely to continue over the next several years. While these negative factors are structural, China has the most near-term control over decoupling and that is where they appear to be adjusting at the margin.

Exhibit 1: China Total Debt to GDP—No Wonder Xi Spares the Bazooka

Source: Capital Creek Research, Bloomberg



Is The Fed Squeezing China?

China's political leaders and Central Bankers have probably come to realize that the US Fed has more influence on their economy than they would like. The Fed's 550 basis points of tightening plus QT has ended up slowing China more than it has the US. The Fed is the Central Banker to the world and a highly leveraged Chinese economy with an ongoing real estate bust is vulnerable to rising US interest rates. Higher US policy rates attract money to the US, reducing liquidity in China and other EM countries. Tighter Fed policy is indirectly slowing China and there is little they can do about it other than raise interest rates, open the capital account, or let the currency weaken gradually, which is the most palatable and likely outcome. A stronger USD/CNH currency (see Exhibit 3) means Americans can purchase more Chinese goods at lower prices. At present, this helps the Fed, it helps the US consumer, and it helps China.

US/China Relations: Moving Past Rock Bottom

US/China relations have been deteriorating since Xi Jingping took power in 2012. Midway through his first term, Xi decided to ditch Deng's "hide and abide" strategy of accumulating relative power quietly. Instead, he chose to directly confront and challenge the US for global leadership. The cost has been high. I believe a moderate course correction has been made and that relations between the two superpowers bottomed out last spring and will continue to thaw. This is evidenced by the fact that in just the last ten weeks, China has received visits from US Secretary of State Antony Blinken, US Treasury Secretary Janet Yellen, US climate envoy John Kerry, and recently a week-long visit by US Commerce Secretary Gina Raimondo. On 8/28, the US and China agreed to resume a regular dialogue about economic and commercial issues. Both countries need each other economically and China has grown concerned about the west continuing to decouple from China wherever possible. Improving diplomatic relations between the US and China reduces the chance of direct military conflict and is unalloyed good news for the world. I believe this thaw in relations would not have been possible with a significant Chinese economic slowdown.

Exhibit 2: China PPI is Back in Deflation

Source: Capital Creek Research, Bloomberg

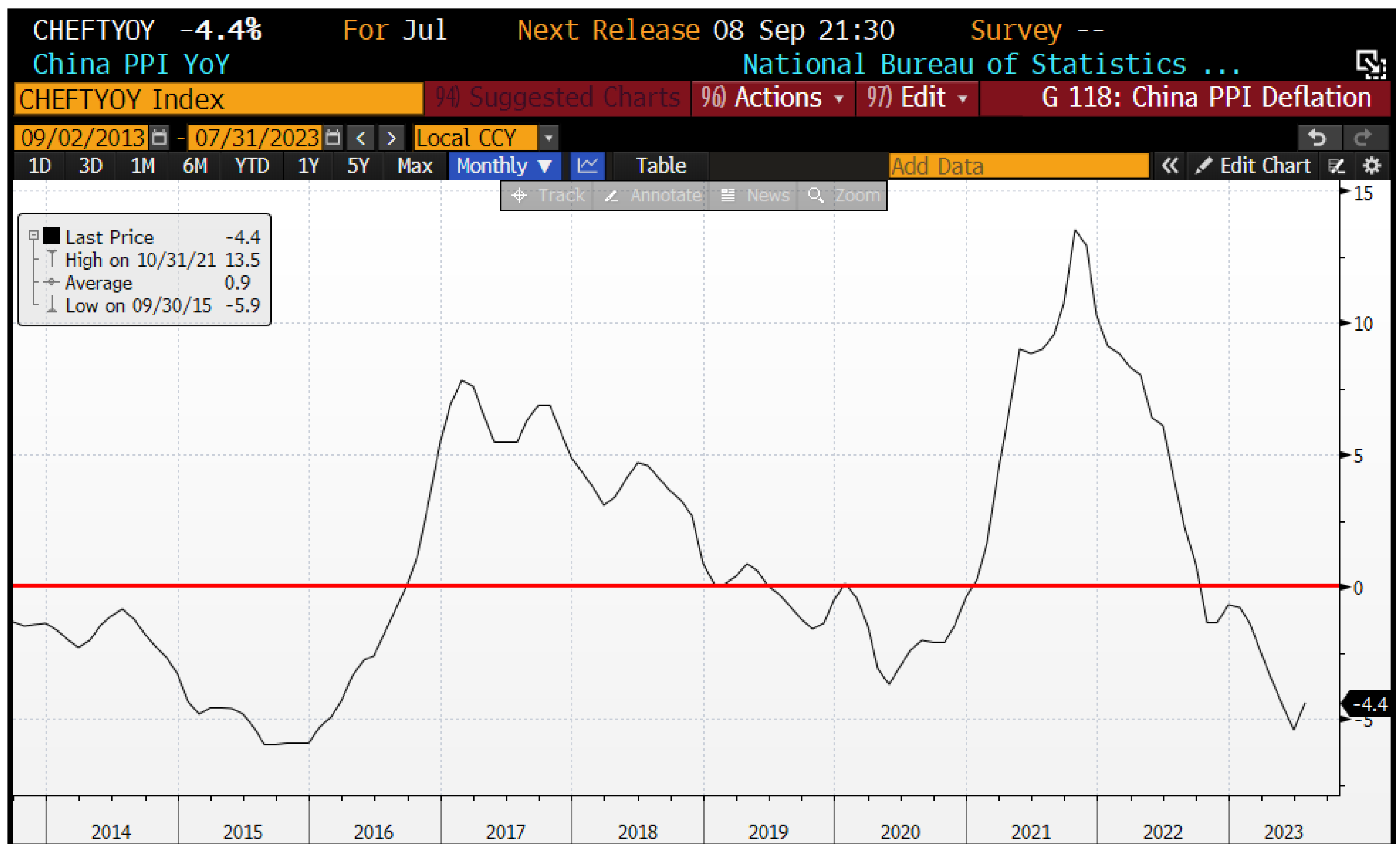


Exhibit 3: Chinese Export Prices Coming Down Hard

Source: Capital Creek Research, Bloomberg

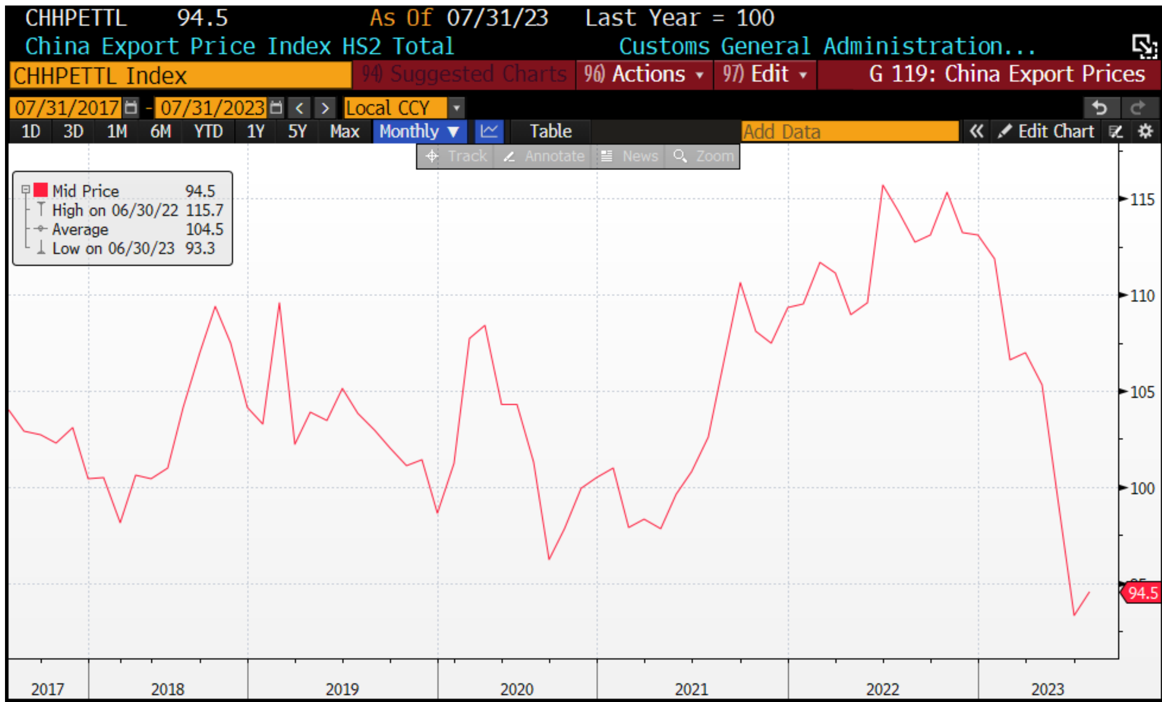


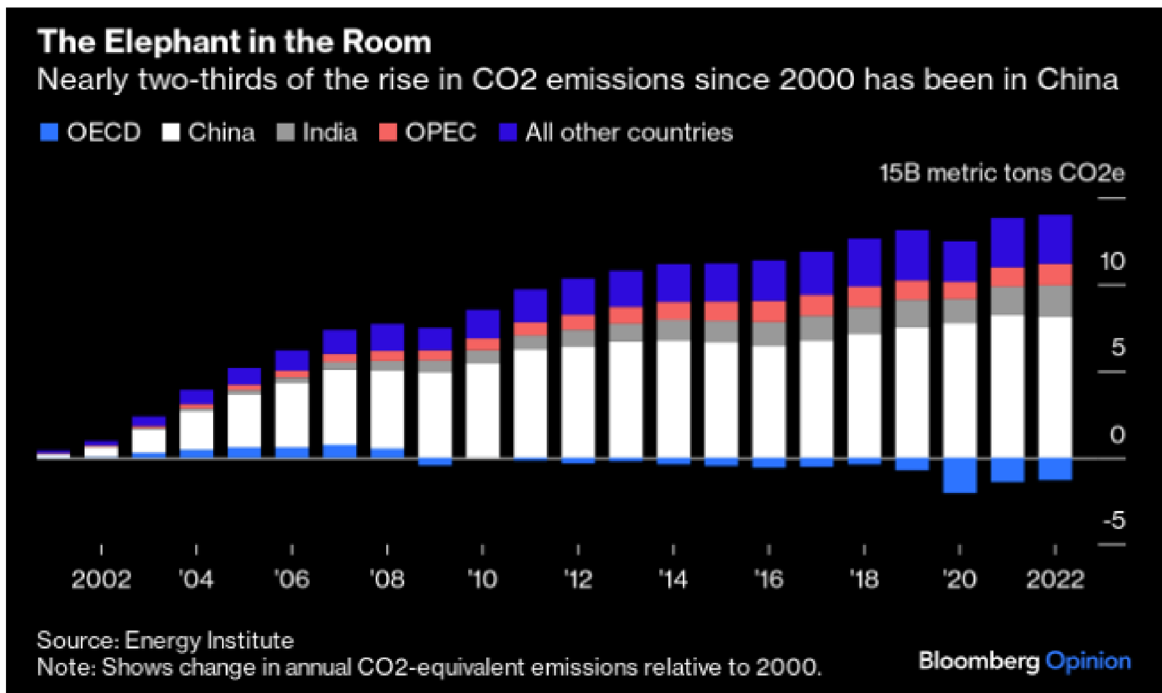
Exhibit 4: USD/CNH Currency—More Room to Rally

Source: Capital Creek Research, Bloomberg

Note: We use the 1 year forward point because USDCNH spot is not freely traded.

Exhibit 5: China the Colossal Carbon Contributor

Source: Energy Institute, Bloomberg



In Conclusion

We have read copious amounts of hyperbole in the press and Wall Street research reports about the coming demise of the Chinese economy. However, we subscribe to a much less dramatic outcome for China. The overhang of debt, deflation, decoupling, and demographics is real and will continue to weigh on Chinese economic growth. We see China muddling through rather than collapsing. Let us not forget that Chinese policy makers have many levers to pull, if necessary, to prevent the Chinese equivalent of a "Lehman Moment." The fact that inflation is so low gives Chinese policy makers plenty of room to stimulate if they so choose. I would contend that a slower, more pragmatic, and humbler China is good for investors and for the world.

Exhibit 6: MSCI China Index—Unchanged Since the GFC!

Source: Capital Creek Research, Bloomberg