A New China: Four Legs Good, Two Legs Bad. (17/07/19)

Your analyst has been writing investment research for professional fund managers for twenty-four years. Throughout that period the driving force behind almost all global asset prices has been the China engagement policy pursued by the developed world. This policy has had a multi-faceted impact upon the global economy and global asset prices, but the crucial impact has been from the disinflation that ensued. The prolonged disinflation from the mobilisation of China’s workforce, combined with a state subsidised cost of capital and an artificially depressed exchange rate, has been the key in depressing global inflation and, with it, the global risk-free rate. Investors who have attended the Practical History of Financial Markets course will know just how beneficial inflation below around 4% has been for US equity valuations. (next teaching session in London October 31st to November 2nd - www.didaskoeducation.org)

Over the past 24 years the US has seen inflation consistently below 4%, and only brief flirtations with deflation in 2002 and 2009 have brought US equity valuations near even average levels. China engagement has also allowed many US corporations to shift to asset-light models, with their production sub-contracted to China. In short, China engagement produced the low inflation, low interest rates and high corporate profits which are the key for a bull market and high equity valuations. China engagement is now over and China containment has begun.

Since last October The Solid Ground has regularly focussed on the words and deeds of the US administration that strongly suggest we have entered a period of China containment and not engagement. Those words and deeds continue, and in early July the US State Department approved potential sales of US$2.2bn of US military equipment to Taiwan. Congress has 30 days from July 8th to object to the sale, but no objection is expected. The arrival of Abrams tanks and Stinger anti-aircraft missiles in Taiwan will clearly not be welcomed by the PRC.

If this looks like a move to a containment policy to you, just imagine how it looks to Xi Jinping and the PLA. The newly opened Twitter account of the Chinese Embassy in the US provides some guidance - “Taiwan is part of China. No attempts to split China will ever succeed. Those who play with fire will only get themselves burned. Period.” The remainder of this report is not about the further growth of the containment policy, but about how that policy has changed the people of China.

Befitting his notoriously sunny disposition, your analyst likes to relax by sometimes reading the history of sieges. While we usually associate the siege with an older period of warfare, the twentieth century saw the most terrible sieges of all time, most notably the Siege of Leningrad. Crucially, sieges are about how those under siege change during the process. A commitment to resist often becomes something more fanatical amongst the besieged and behaviour changes and acts, once considered to be beyond the pale, become commonplace. There is already ample evidence that the authorities in China, and the people of China, are changing their attitudes and behaviour as they witness the shift from an engagement to a containment policy.

“Government officials in the Chinese tourist hotspot of Hainan have told popular hotel chain Vienna International to change the name of its branches because their reference to the
European city reflects, “worship of foreign things”... The civil affairs bureau in the island province has issued a list of dozens of businesses with names that should be “rectified” because they suggested “worship of foreign things”. The Hainan government official, who the state-run newspaper quoted but did not name, said the province’s effort were part of a national campaign.”

Financial Times, June 19th 2019

“In an internal announcement issued May 16 by the Jinggang Motor Vehicle Inspection Station located in Donghai County, Jiangsu Province, the company echoed the propaganda, explaining that China’s developments in military, science, and technology have frightened the United States. As a result, the United States started the trade war with China. “To help our country win this war, company authorities have decided that all employees must immediately stop purchasing and using American products,” the notice read. The refrain that the United States is impeding China’s rise on the global stage has been repeated in much of Chinese state media lately.”

Epoch Times, May 21st 2019

“Chinese consumers are souring on American products amid a bruising trade war. As the two countries continue to negotiate a potential truce on tariffs, a new survey finds that 56% of Chinese consumers have boycotted an American product “to show support for China.”

USA Today, June 28th 2019

If a people who increasingly see themselves as under siege change their view of foreign products, this should be evident in import numbers and China’s imports are indeed contracting despite reported real GDP growth of 6.2% in 2Q. Import growth of US products has seen a particularly rapid decline of 31.4% in 2Q 2019. This is not just about changing attitudes in China towards US products, but a shift to a siege mentality is important as it can persist even if direct action by the state to reduce imports comes to an end. While such a shift by the state is possible, it is not probable, as there is evidence that the state is preparing for a siege/containment and not a trade war.

It has been evident for many years that China has been preparing for the time when its economic growth level would take it necessarily into a current account deficit. In preparation for that time Chinese authorities have been encouraging capital inflows into China. This has taken many forms. Foreign central bankers have been cleared to own RMB-denominated assets as part of their foreign reserves. Foreign ownership of financial institutions is now permitted to exceed 50%. The stock-connect and bond-connect programmes have cleared the way for Chinese equities and bonds to be included in key global stock and bond indices.

The clamp-down on the outflow of local capital is also part of preparing China to run a current account deficit by running a capital account surplus. In a world of China engagement such a policy seemed reasonable. In a world of China containment the CCP must now regard such a policy as dangerous. A people under siege cannot rely on help from beyond their walls and help from foreign capital, ultimately subject to the laws of its own country, cannot provide reliable funding for a current account deficit.

Given this new dynamic, China must shift its policy to become increasingly self-reliant, and to import less, while continuing to grow at a reasonable rate. China containment means not just different behaviour by China’s clients but it means different behaviour by China. Investors must expect that China’s siege mentality, amongst the CCP and also increasingly evident amongst its people, will be to shun foreign products as a reaction to the China containment policy. There are clear negative consequences for foreign firms selling their products in China.

In various quarterly reports (available to subscribers) your analyst has assessed the market impact, both short and long term, of the move from China engagement to China containment. In short it augurs a final
deflationary bust, primarily through a collapse in commodity prices, but then a move to much higher levels of inflation. If developed-world growth holds up during the deflation, then equity valuations will rise but such a combination is unlikely, particularly in Europe where growth is already sluggish and where there is a particularly heavy exposure to the Chinese investment cycle. Subscribers will know, from the 2Q 2019 report, that there is a much greater chance of a melt-up in US equities as The Solid Ground foresees a return to major Fed purchasing of Treasuries in October.

Your analyst lived in Hong Kong from 1995 to 1998. During that period I witnessed how the CCP generally tried to dampen nationalist feeling in China. Particularly in relation to disputes over islands in the South China seas, the official press tried to dampen any sense of a national crusade to claim such islands despite moves by private groups of Chinese to do so. Perhaps the CCP feared that nationalism is the only true threat to rule by the CCP. Letting nationalism out of the bag in China can result in mass actions which are difficult for the party to control.

We have not yet come to the stage where Chinese nationalism is the driving force in China. We may not get there. However, those under siege are not like you and me - they do things differently there. It is very difficult to see how containment does not breed Chinese nationalism, and Chinese nationalism is not a force that leads to greater exports to, or investments in, China. Just how well the CCP can control the mood of the people is difficult to assess, but the longer the siege continues, the longer the risk that investors have to cope not just with containment but with Chinese Nationalism.

In George Orwell’s Animal Farm it was Snowball who summed up the new policy of the farm as, ‘Four legs good, two legs bad’. After Snowball had been purged the slogan took on a life of its own and led to behaviour that had previously seemed impossible. Containment brings a new China and if it’s a China of ‘four legs good, two legs bad’, then it is a China were the irrational can become the rational and the rational will become increasingly rare. While nationalism is hardly the exclusive preserve of China, the rise of nationalism in China increases the risk to currently elevated equity valuations built upon an engagement that could soon be seen as a policy dead in both the US and China.
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