FRIDAY, AUGUST 18, 2023

Well, hello and welcome to Dividend Cafe. I have been very excited for some time to bring you a treatment on this subject about China's weakening economy and what it means to this kind of state of global affairs. There has been so much talk for the last couple years about inflation. Inflation of prices in the United States, in Europe, United Kingdom, and so little talk about deflation based on the inflationary environment that the post covid world represented.

That to all of a sudden have a major financial story, news story, geopolitical, global. Stories, centering around deflationary conversation is, seems somewhat surreal to a lot of people, and yet it is my contention that a lot of what is happening in China right now has a certain precedent in history and I wanna walk through what exactly is happening.

And how China got to the position they're in now. And then where some of the similarities to Japan in the late eighties, early nineties, and the decades that have transpired since. And some of the similarities, by the way, United States and their property bubble in that led into the 2008 crisis where some of those similarities exist.

And see if we can't draw some conclusions here now. . I purposely have done this in a way that I think as I reread what I've written and what's a pretty long dividend cafe I think it is pretty understandable and coherent, and yet it's a very complicated topic and so some of the understandability or coherence of it may be a byproduct.

Of the fact that I'm trying to simplify things that do have a lot of nuance and that do have a lot of complexity. So I hope you can understand that. There is no way to simply say . China did this. Now this will happen. And if China does this exactly like this, then exactly this will happen. There are shades of gray into what some of the policy responses may be to the current state of affairs.

There are shades of gray around what those what that state of affairs itself may be. So allow me to unpack it as best I can and we'll see if there's more clarity when all said and done. And I think you'll find . There's a shared set of principles that permeates what I do at Dividend Cafe, what I believe in economically, and from the vantage point of being an investment manager all the way through.

And hopefully that will hold true here today. So when you talk about deflationary risk coming back to China, in a world that has been dealing with an inflationary problem, how does this come to be? Well, generally speaking, . When we're talking about real deflationary risks, the real threat of a spiral where actions you take can exacerbate and make things worse, you're dealing with a debt overhang.

That you attempt to deal with, and by doing so, the price of assets drops even more than you're reducing the debt. And China's particular debt overhang is much more in their property sector than it is in governmental debt per se. See there, there's some complexity to this because the United States.

Has sign does not have a nationalized economy, right? Where there is a significant amount of government owned enterprises, government owned assets. So when we talk about debt and GDP in the United States, we're talking about a private sector, GDP, and looking at governmental debt, that and a drag on that GDP and with Japan.

Their balance sheet issues started with their property sector, where then their governmental sector got involved to offset the damage to the property sector. And of course, United States, you have a similar story. There was a fiscal and especially a monetary response. To the property bubble bursting, the financial crisis, the credit bubble of 2008.

And then it led to a policy response that brought in governmental forces. China's starting point is a bit more complicated because a lot of the lenders, in some cases, a lot of the developers and property holders themselves are quasi nationalized. There's a lot of state-owned enterprises, but I think the general principle is simple enough that even with some blurry lines between the hats, different forces are wearing really what they are dealing with.

Is impediments in their property sector whereby it has gotten overheated and more credit was extended than could be paid. Property projects have not been finished. They now trade at prices lower than the break even of the developers . There is just, again, a number of different things like this that are all symptomatic of a collapsing, problematic, distressed real estate environment.

And so the source of the deflation comes from the economic . Ramifications of that, that when you now have less building going on, you have less jobs. Particularly they have over 20% unemployment for their young working age, adult population and their, now it isn't that high across the population. But when you're seeing people between 20 and 24 with unemployment of 22, 22 0.5% you're talking about an extraordinary number that is a byproduct of so much downturn in opportunity in what was the major growth sector of the Chinese economy.
Now, because China is largely an export driven economy, there is sort of more to this chicken or egg. They have just seen an explosion of global trade, as we all know, for the last, let's call it 30 years particularly the last 25 years. And now you have year over year imports and year over year exports going negative in terms of their growth.

They are seeing a real slowing and in fact a contraction. In this trade activity that feeds the economy, so much of their imports are a byproduct of the growing amount of exports that it's led to the need to import more to meet the needs of their society, which are positive needs. There's more economic activity, a lot of which they have to feed the imports that are dropping.
But of course, what feeds the old dragon for them has been exports, and that is no longer growing or thriving. You have a

property bubble slowing, so then that feeds on itself and that leads to lower jobs, which leads to lower wages, which leads to lower demand, lower consumption in an economy that is in desperate need of more consumption because they have lacked it.

For so long. Then you add to that the peripheral decline in industrial output and manufacturing that goes with the less construction, which has been such a growing part of their economy. . You need more, they did not have. A well amenitized property sector, high quality of life that would be proportionate to the size of the economy they grew into.
So they exported so well. They produced so well, they grew so well. Now they needed more property and they got significantly over indebted and now face the ramifications of dealing with this slowing property dynamic. Okay, well here's the thing. When you have a decline in house prices to stabilize, to bring back equilibrium, to supply and demand, I've always upheld, I, I think that's a good thing.

It's a positive thing, but when you have prices dropping, when millions of homes have not yet been built, that require the higher price. To rationalize the building, you lead to a lot of bankrupt projects, developers just packing up and leaving, saying, if we were gonna get X, this made sense. We're now gonna get less than X.

It doesn't make sense. We're washing our hands of it. And now you see one of the largest home builders facing a bond default, the largest facing a bankruptcy. And so then the trickle down effect of that, Leads to the state owned enterprises. In their property sector picking up a lot of the slack, which of course pro produces even more competitive problems for the non-state owned enterprises.

And then that feeds this whole problem of less production and and less activity in the overall sector. That's the general lay of the land. Now you say, okay, well what is the, what are the consequences been? I mean, you say there's less industrial output, but that sort of seems to be repeating the problem, not explaining.

And when we talk about deflation, you have producer price indexes that are down 4%, over 4% year over year. You have consumer price indexes that have even gone slightly negative, and this is all in a world a wash with price inflation as you have Europe, uk. Canadian and certainly American Central banks trying to counteract higher prices and China dealing with lower prices, which of course then risks that debt deflation cycle, which which could be so fatal to, to an economy.

I think that China will end up trying to solve much of this problem before I get to the fiscal and monetary bazookas. If nothing else, just even trying to stimulate within the property sector through subsidies, I. And benefiting their state-owned enterprises at the expense of non-state owned, which I think leads to less competition, less quality less market forces.

And it, and it distorts what is something that is already a highly distorted market. But even that just represents, I think, the tip of the iceberg to where this thing will go. Now, what do we mean when we talk about support? Do we mean ? Removing impediments towards greater production, towards a more robust property market.

'cause there are impediments, and this is sort of one of the things that where the supply side in Kinsey and rhetoric sometimes can sound similar because I am all for stimulus when it means removing unnatural impediments. And, and yet that of course is what the supply side definition would be. Where the Keynesian definition would mean creating a stimulus via an intervention, via a distortive intervention. Which is a very different story. I. China has many policies on the books right now that could be removed, that might be a really needle moving, various limitations, various regulations that are impeding a healthy and, and naturalized. Property sector and perhaps removing those things without the direct subsidy of state owned enterprises, let alone without things like that, are being heavily discussed by senior members of their own monetary committee.

Think of it like their version of the Fed at the P B O C, the People's Bank of China. Like direct payments to consumers over a 4 trillion yuan being discussed to be distributed directly. Now that has not been agreed to. They have not done that. And so there are, it's one thing for an m i t economist America to say, boy, they really need to do that.

But it's another thing for them to do it. My point is that there is a kind of global consensus forming and they're just debating on, on at the margin. How much does China need to do to go support their household sector, direct payments, subsidies, incentives to, to property sector? My view would be that there is a lot they could do just simply to remove impediments. I do not think it will stop there, and I think that the overwhelming rhyming of history is that they want to stimulate demand for credit. This is where they've cut rates now twice this summer, unexpectedly, not significantly. They're not down to the zero bound yet. And while I don't think there's any doubt that they're gonna go down the fiscal stimulus path of more, of more subsidies, more government spending, more support to their housing market I don't know that they will go down the same path that the B O J and the Fed have in terms of this Addiction to monetary policy, but that's the hinge on which Japan ification turning to China ification will, will turn, do they end up adopting an aggressive belief in reducing the cost of capital as a means of stimulating economic activity. Because I have not seen a developed economy in the modern era go down the path of using fiscal stimulus without marrying it to monetary stimulus.

I'm highly skeptical that they will do the fiscal and not the monetary. I think that the monetary will follow the fiscal, however that isn't a foregone conclusion. But why would I argue? That the monetary would be a mistake. Simply put, and this is a very important economic lesson, I always want dividend cafe listeners to understand when you are dealing with an over indebted entity, whether it's a government, a household, or a corporation, reducing the cost of capital is not the most significant problem.

What we would call a balance sheet recession to borrow from the Great economist, Richard Coup their problem is too much debt. You can turn the knob on the cost of the debt all you want, but the problem is that by taking more debt to solve a problem of too much debt, you have obviously not solved the problem that you are now dealing with a diminishing return on taking more debt.

And in fact, you really have no appetite, no demand for credit. When the problem is excessive amounts of credit. You will not get borrowers to take on more debt when they're concerned about the health of the property sector. They've been through Covid lockdowns, they've seen asset bubbles deflate. You can lower the cost of capital all you want.

You begin this Japan ification pushing on a string negative feedback loop that I talk about all the time. When you go down this path, understanding that the problem for too much debt is to have less of it, not to manipulate the price of it is the great. I guess lesson I would propose here and in this I am firmly in the tradition of many of my Austrian economist friends.

Certainly in terms of contemporaries, the great Jim Grand has sort of made a career outta saying things like this, the cost of capital is not the problem. It is the amount of debt, and yet if they go down the fiscal path to stimulate the property sector. I just wanna be very clear here. I do not predict it will fail. I predict it will very likely succeed for a short period of time. That there will be a sugar high, there will be a benefit. There will be reflation to risk assets that they have, policy tools. Some I would favor like removing impediments, some I would vehemently oppose, but both of which would likely have this impression of benefiting what they're trying to do and then in and then marrying that fiscal overreach to a monetary overreach.

That's where you get unification. And that's where I think the world needs to be watching because first of all, I think a lot of the world's gonna be rooting for it. We don't wanna see global trade go down. Having an economy the size of China's go down this path would do so much short-term damage. So let's all hope that they throw fiscal and monetary at this to solve for it.

Ultimately a world where US is growing at 1.5%, where China's growing at 0% and we're trying to get a certain global GDP growth that has been coming from a 4, 5, 6, 7% Chinese growth, and all of a sudden if they Japan unified the Chinese growth down to stunted levels, I think you're very likely. Very likely going to see a huge impediment to global GDP growth as China exports their deflationary pressures.

I just cannot imagine why any of us would want that to happen. Now, of course, there aren't any people who want that to happen. What they would do is deny that it will happen and state that it's different or there's, you know, certain circumstances that would make this a bit different. And there are . I have a chartered ding cafe that shows the difference between what Japan's property bubble looked like before its deflationary crash and where China's is, and they don't look the anywhere near the exact same.

The violence of Japan's bubble was just something the world is had never seen, hasn't seen since, really, but the principles are the same. And because of the size of China's economy. The far greater global interdependence on their activity, particularly as an exporter. I believe that there will be big ramifications to global growth that China goes down this path.
So I do not offer up this dividend cafe out of my concern for what the CCP will do. I'm not simply talking here about what I would do if I were a Chinese investor or a Chinese policymaker. I speak with my primary concern being the proximity of us, investing us investors, doing us investing, and the fact that the a country size as China's may go down this path of wanting to utilize fiscal and monetary distortions to solve some of the problems. I do not believe it works. I believe it feels like it works for a period of time, creates a bigger problem later, and that we are now potentially entering an era of China ation at the same time that we're dealing with US China tensions around technology, around supply chains, around the US looking to reshore, as I wrote about a few weeks ago, many of their manufacturing endeavors.

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While there are geopolitical tensions around Taiwan but this idea that China, to give you an idea of how challenging a deflationary bus can be, they're they weaken their currency about 15% of the dollar. So you would expect their wholesale prices to be up about 15%. All things being equal and all things are never equal.

I understand that. Instead, their producer prices are down 4%, not up 15, to keep in line with the currency depreciation. So see, sometimes when you start weakening currency to manipulate these things the cycle takes hold and it's very, very hard to put that genie back in the bottle. I think that we are looking at a non Chinese domestic problem whereby the Fed having raised rates so much.

Now the only way that I think because see, what does China do? They wanna go weaken their currency. They go they wanna go, or what if they wanna strengthen their currency, are they gonna buy more yuan and sell dollars? See, I don't think they want their currency weakening much further. But if they do that, they're then monetary tightening at a time that they're saying, oh, we gotta stimulate, we gotta stimulate, we have this property problem.

So how can they stimulate by buying more of their own currency when in reality, that would have a non stimulatory or an anti stimulatory effect. They're stuck. Now, could the Fed do their work for them? Could the Fed begin cutting rates and helping weaken the dollar, strengthen the wand without them having to tighten their own monetary policy?

Potentially. But do you think right now the Fed is thinking about Chinese economic interest? I don't. So there is a global ramification of what the fed's done and what China will do. And it, this notion of decoupling is silly. Everybody is affected by what the others are doing. And my argument is to finally just simplify this and bring it to its conclusion.

What China's doing invites consequence to the rest of the world if they export deflation. They do that now with their various fiscal and monetary interventions, perhaps helping their own economy. At the same time dooming them to lower GDP growth, lower economic growth into the future. A future, which by the way I've pointed out in the past, has decades ahead of it of very, very weak demographics of an out and out population decline.

So my argument would be the identical argument I've made about Japan ification and about the various US efforts that I think have led to a US version of Japan. Ification muted economic growth here in the United States, China going down this path, if they were to do so, head over heels, not just flirt with fiscal stimulus, but really embrace monetary.

I think that you're looking at unification becoming a bigger word in my lexicon than Japan ification. I hope that does not happen. But regardless, knowing what we already know about overly indebted societies, overly indebted nations, and the economic consequences of that and the economic consequences of how these policy makers try to deal with that I cannot emphasize enough.

A focus on quality in a portfolio, and that is of course the be all, end all of what we want to do as investment managers. I'm gonna leave it there. It was an ambitious topic to bite off this way. I certainly invite questions if there's a desire for more clarification, but I hope I've helped kind of succinctly frame. Where all this lies, and I invite your questions and we'll probably be doing some postscript on this subject in the days ahead next week in DC today. So thanks for listening. Thanks for watching. Thank you for reading. Of course, Dividend Cafe. That reading Div Cafe may benefit you this week.

There's some charts and other things. I always feel that the written word helps me capture the points I wanna make better, but I'll defer to you there. I look forward to coming back to you again next week. Thanks for, again being part of Dividend Cafe.