Weekly Market Flash

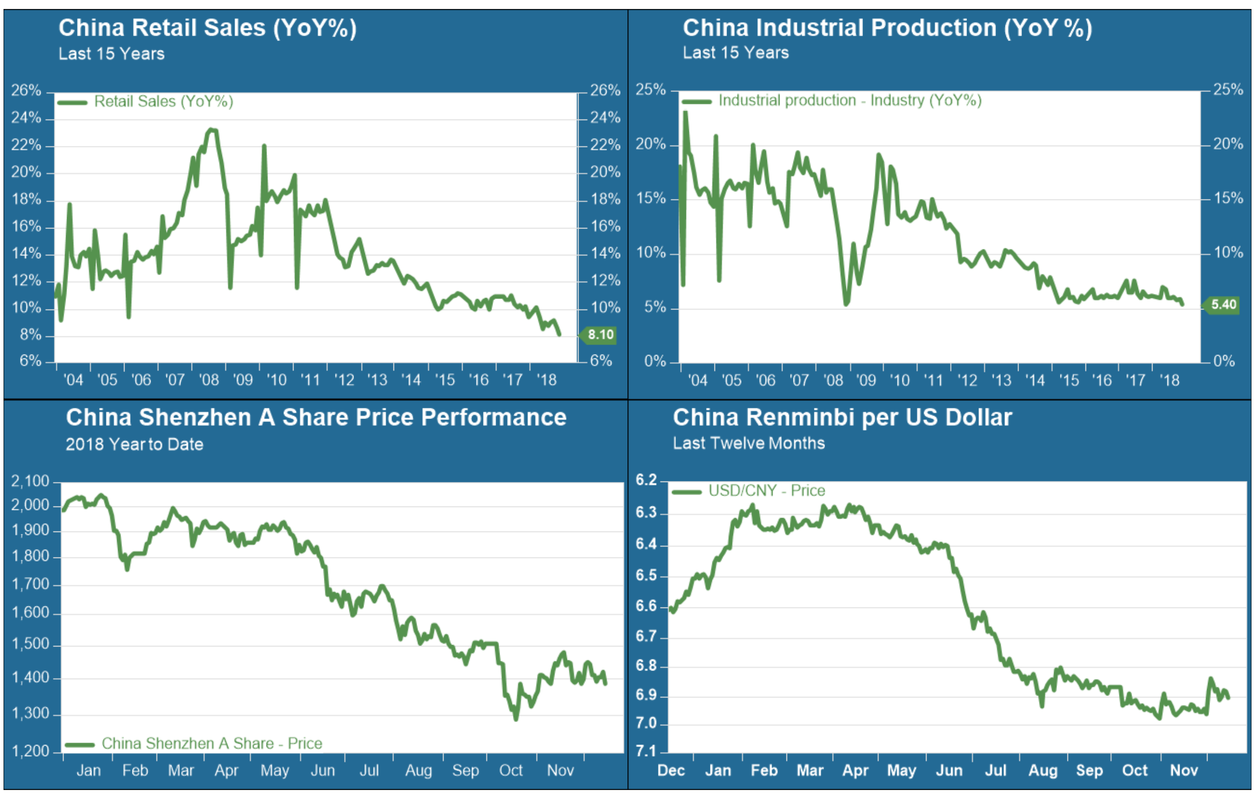
China's Rebalancing, Interrupted

December 14, 2018

The Lunar New Year in 2019 falls on February 5, a bit shy of two months from now. According to a New York Times article today, managers in some factories in China – where Lunar New Year is one of the big holiday events of the year – are letting their employees off for the holidays starting this week. Imagine if your boss came into the office one sunny October morning and said "Merry Christmas all, and I'll see you in January!" Pretty weird. Such, apparently, is the extent to which the cadence of growth in the world's second largest economy is slowing.

Tales From the Not-Yet-Trade War Front

A rather dour investor sentiment has been traveling across time zones from east to west this morning, cutting a swath of negative figures through the major equity indexes of Asia and Europe before showing up for another down day on Wall Street. The culprit appears to be another set of macro data releases from China coming in way below the already modest expectations of analysts. We show two of them below – retail sales and industrial production – along with the current state of things in China's equity and currency markets.



Source: MVF Research, FactSet

Both these figures are notable in that they represent multiyear lows: in the case of retail sales, a 15-year low. Robust double-digit growth in sales has been the norm even through the 2008 financial crisis, but today's read is just 8.1 percent year-on-year growth. The other point worth making is that these numbers have relatively little to do with the trade war. China's exports have not turned down notably even after the implementation of successive waves of tariffs by the US. The problem appears to be domestic sentiment – households are turning down the volume on their spending habits and businesses are cutting production shifts accordingly (hence those extended "holiday breaks" noted above).

Old Habits Die Hard

We've been writing about the "China rebalancing project" seemingly forever. For literally the entirely of this decade to date, Beijing has loudly proclaimed its intention to move the economy beyond the old formula of massive spending on state-run infrastructure and development projects, towards a more consumer-oriented society closer to Western economies in terms of consumer spending as a percentage of GDP. By some measures it has succeeded – while official published figures from China are not necessarily reliable, consumption has grown as a GDP contributor over the past ten years. But the old fallback growth formula of debt-funded infrastructure has not abated. Indeed, fixed-asset investment, led by housing and infrastructure, hit a five-month high in the most recent data release. With debt levels already sky-high, though, there is a serious question about how many more times policymakers can go back to their old quick fixes for further growth.

Abroad and At Home

China's slowing domestic economy is a major reason for the weakness in global energy and industrial commodities prices that has persisted over the past several months. That, in turn, seems to be having a positive impact on consumer spending here at home. With gas prices down a couple percent over the past month, US retail sales for the same period jumped by 0.9 percent month-over-month, exceeding analyst expectations (this refers to the so-called "control group" basket of retail goods and services that excludes volatile categories like automobiles, building materials and food services). November was a particularly bright month for big-ticket items like furniture and electronic goods.

US companies will be hoping that trend keeps up domestically. The average S&P 500 company earns around half of its total revenues from markets outside the US, notably China and the EU (which is having its own particular growth problems). Flagging demand in those markets will be a drag on the pace of sales and earnings growth, which in turn will put pressure on stock price valuations, which in turn could feed into prevailing negative sentiment towards risk assets generally, which in turn can spill over into spending plans by households and businesses, which eventually has the potential to lead to recession.

Protectionist and nationalist rhetoric may fill the political airwaves around the world, but it is still a globally interlinked economy, where the fates of consumers and business managers in China, the US, Europe and elsewhere are joined at the hip.

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