MV CAPITAL MANAGEMENT

Weekly Market Flash

A Deflating Week for China

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We have been in this business long enough to remember all the "Japan as Number One" mania of the 1980s. Those were the days when straight-faced financial reporters informed us that the three square miles of the Imperial Palace grounds in downtown Tokyo were worth more than the entire state of California (yes, really). All that nonsense ended on December 29, 1989, the last trading day of that decade, when the Nikkei 225 stock index hit an all-time high of 38,915. Thirty-three years and change later, that is still the all-time high for the Nikkei index, which closed out the current week at 32,475, still more than 16 percent down from the 1989 peak.

Exports, Property and Prices

We are not going to try and make the case that China's situation in 2023 is a repeat of Japan's in the early 1990son. But there are some similarities that are worth paying attention to. This week served up a handful of economic reports that called a few of these similarities to mind. On Tuesday we learned that China's exports fell by 14.5% from a year earlier, a bigger than expected drop and a reminder that China is no longer the export powerhouse that it was in the early years of the twenty-first century.

That same report also showed a double-digit drop in imports, which highlights another current weakness in the Chinese economy: consumer demand. When Beijing lifted the austere zero-Covid restrictions in November last year there were widespread expectations of a consumer-led boom in demand for goods and services. That boom has largely failed to materialize. Retail sales in recent months have also been muted. China's economic policymakers have for many years been trying to rebalance economic output to a more consumer-focused model; so far, those attempts have largely fallen flat.

What has until recently driven much of China's growth has been its property and infrastructure sector, and another report this week reminded us why this is an ongoing problem. Country Garden, the country's largest private property developer, missed interest payments of $22.5 million on two international bonds. Country Garden was supposed to be proof positive that the property sector had overcome its recent troubles; instead, the missed interest payments set up the potential for yet another prominent default, fully two years after the Evergrande collapse in 2021 set the unwinding of this sector – which contributes around 30 percent of China's GDP growth – in motion.

Finally, prices at both the consumer and the wholesale level are deflating in China, even while most of the world's other major economies continue to work at bringing down inflation. Deflation is a natural outcome of the problems reflected in those other reports – weak consumer demand, lackluster exports and a property market stuck in reverse. In many ways, deflation is a worse condition than too-high inflation, because it encourages hoarding at both the household and business levels and sets the stage for a years-long downward spiral. This, indeed, is what Japan experienced in the 1990s when its own property sector went bust, overextended banks stopped lending and households stopped spending.

Beijing's Long Game

For all the similarities, though, China in 2023 is not Japan in 1990. For one thing, Beijing does have a specific strategy for long-term growth, something that cannot be said about Japan's policy mandarins at the Ministry of Finance in the 1990s as they circled the wagons around their failing financial sector. China's strategy has two key components: first, consolidate its position as the dominant supplier of the raw materials needed for transition to clean energy; and second, invest heavily in forward-leaning sectors including biotechnology, quantum computing, artificial intelligence and semiconductors.

This strategy may or may not work. In semiconductors, for example, China's domestic capabilities are far behind those of leading centers of excellence elsewhere, including Taiwan, Japan and the US. The geopolitical climate is uncertain, to say the least. And it is entirely unknown whether there would ever be enough practical use cases in areas like AI and quantum computing to offset the ongoing decline in the erstwhile growth engines of property and infrastructure. That being said, there is a definite logic to the strategy, and it would be a mistake to ignore its potential for success one day. In our view, however, that day is not today.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research