MV CAPITAL MANAGEMENT

Weekly Market Flash

China In 3D

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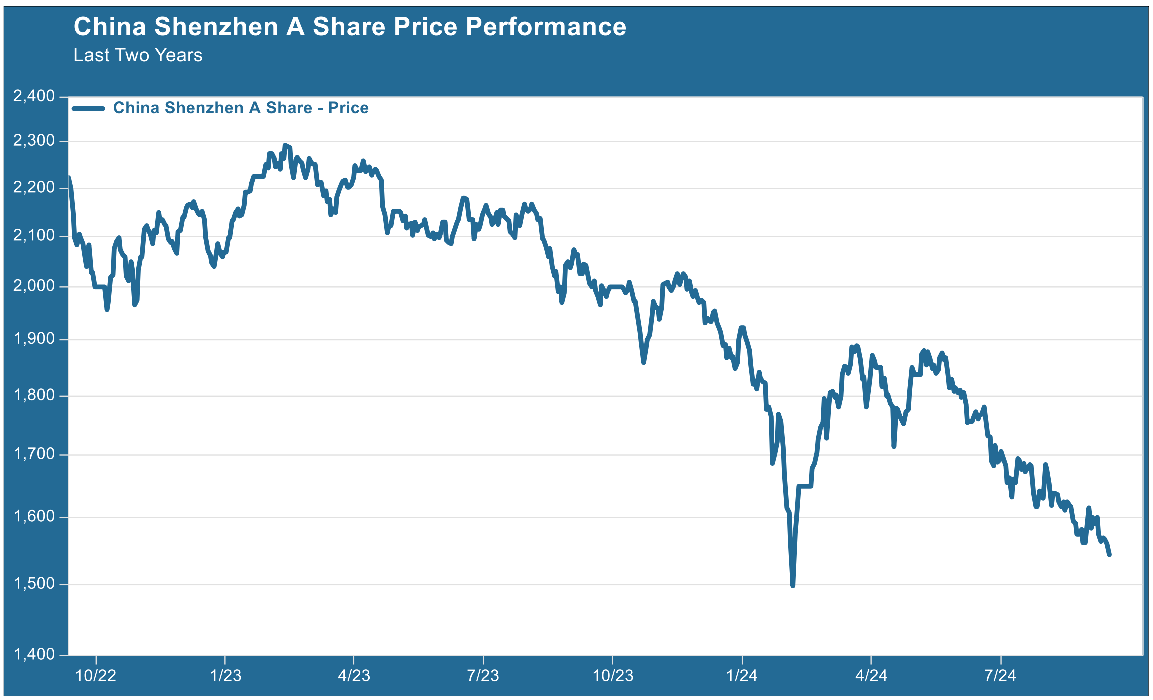
Demography, deflation and debt. These are the Three Ds of China's economic lassitude, and they have all been in the news recently. International investors, meanwhile, continue to add a fourth D to the picture – departure. The Shenzhen A shares index, a bellwether of mainland Chinese equities, is down 32 percent from its 2-year high set in February of last year. And it's not just portfolio managers with their fleet-of-foot capital heading for the exits; US and European businesses with longstanding foreign direct investment in China are rethinking the dependence of their supply chains on a China that has become increasingly difficult to deal with, both economically and politically.



Source: MVF Research, FactSet

Where Have All The Workers Gone?

China's demographic problems begin and end with its dependency ratio – the number of retirees relative to the working population. That number has been going up as the population ages and the birth rate, even after the end of the disastrous one child per family experiment, declines. Economists project that China will add around 20 million people to its retirement rolls each year from 2023 to 2035, straining its badly underfunded pension system. This week, the government announced its intention to raise the official retirement age for the first time since 1978, gradually extending the age for men from 60 to 63, for women in white-collar jobs from 55 to 58, and for women in blue-collar fields from 55 to 58.

The Japan Syndrome

No amount of tinkering with the retirement age will help China deal with a deep consumer funk that threatens its growth prospects as far ahead as the eye can see. Consumer prices are teetering on the edge of outright deflation – China's consumer price index currently sits at just 0.6 percent year on year, compared to the 2.5 percent headline CPI number for the US released earlier this week. Households have cut back on spending as the country's property crisis grows deeper and deeper with little in the way of economic assistance from Beijing. China's household savings rate is an astonishing 31 percent. When the government does step in, it does so in an oblique way by pumping liquidity into the manufacturing sector, apparently in the hope that industrial production will boost exports and thus circulate money back into the domestic economy. A news article in the Financial Times this week cited a handful of economists arguing that under current conditions, China would need to spend some $1.4 trillion in stimulus outlays to put the country back on a long-term sustainable growth trend.

Bond Bubble

When economic growth prospects look shaky, investors seek safety in fixed income markets, and China is no exception. Massive purchases of government bonds has driven the yield on the 10-year benchmark bond down to an all-time low of 2.1 percent. Banks and nonbank financial institutions have been leading the charge, giving rise to fears of a bond bubble that could decimate banks' asset quality if rates were to suddenly spike up. As they could well do, given that the total amount of new government borrowing between August and December of this year is estimated to be close to $400 billion. Xi Jinping's long-term economic strategy calls for substantial investment – meaning lots and lots of debt issuance – in leading-edge green technology to establish global dominance in what Beijing expects to be the growth drivers of the coming decades. The success of that long-term vision is anything but certain; meanwhile, the already-precarious state of the Chinese economy could unravel further still with a widespread debt crisis.

China is the world's second-largest economy – in fact, it is the largest when ranked by purchasing power parity. The Chinese supercycle, which lasted from the early 1990s through the first decade of the 21st century, is the fastest growth cycle ever recorded in human history. Thus, its current economic troubles reach far beyond the shores of mainland China. The country's weakness is a key factor, for example, in the economic travails of Germany, whose usually reliable exports of high-value manufactured products languish amid weak demand from China, its biggest market (and these conditions, in turn, explain a good part of Germany's current political troubles with extreme right wing and left wing political parties winning three recently-held regional contests in the county's east).

Meanwhile, even with its diminished domestic equity markets, China still makes up around 25 percent of the MSCI Emerging Markets equity index. One way to understand the chronic underperformance of emerging market equities, as we have noted in commentaries over the past several years, is to understand the 3D problem of China – demography, deflation and debt – that does not appear to be going away any time soon.

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