

China Hard Landing. The Chinese Recession and the Threat to the US Economic Recovery

In Nov 2011 I warned that the Chinese economy was headed for a slump. This is an update. In the past quarter, manufacturing data has supported the view that the Chinese economy was decelerating rapidly.

The much watched inflation numbers have come off as well providing policy makers room to ease. However, despite recent weakness, food prices remain elevated and may stay the hand of policymakers from outright interest rate cuts.

The real estate sector has also cast a pall on the economy. Here, the slump is the result of government policy to cool an overheating housing market. Rising house prices do not increase welfare; to the contrary, at lower levels of home ownership, they decrease welfare, something surely not missed by a Communist country. Policy has therefore been steadfastly tight on the real estate sector resulting in falling land and property values. The flipside to this policy is that the value of collateral falls and the construction industry slows.

The most interesting sign that China is in the grip of a serious slump, however, lies in the anecdotal evidence that the number of factory workers returning after the Chinese Lunar New Year to work in the coastal cities and traditional manufacturing centres has slumped. What is interesting is that this has been interpreted as workers having found employment in the provinces and therefore not returning.

By speaking to a number of businesses and investment managers in the mainland, the feedback I received late last year was that the slump in workers returning to work after the Chinese New Year was to at the time expected, but for a different reason. The expectation then was that employers would take advantage of the annual pilgrimage to lay off staff.

Laying off workers at any other time involved paying for their train ticket home. Moreover, the risk remained that workers would picket factories instead of going quietly. During the Chinese New Year, workers pay their own fare home to meet with family. If they were let go then, they would also be less likely to travel back to their factories to demonstrate their disaffection. This thesis having been built last October / November has seen empirical support.

The performance of stock markets has been instructive. In the last quarter, Japan stocks rose because the BoJ is printing funny money. European stocks are also rising because the ECB is printing funny money in vast quantities. US stocks rallied since 4Q 2011 in a delayed reaction to economic recovery begun in 3Q 2011. Of the BRICs, China and India have underperformed despite rallying early in the year. In India, political parties attempt mutual and often self destruction with the private sector as hostage. China's problems are similarly difficult with a change of management on the near horizon as the economy begins to look slightly unhinged.

China suffers from rising wages, rising food prices, an overleveraged shadow banking system established to finance the massive Keynesian infrastructure binge just post 2008 and export partners who are retrenching and increasing their savings rates. Economic growth based on investment and government expenditure can only go so far. And it appears that it has.

Some people believe that whatever happens anywhere in the world tends to impact Asia, sometimes disproportionately. Given the rise of China in the past decade the converse is also true. One has to question the robustness of the US recovery if it has been based on capital goods exports to resource countries supplying Chinese infrastructure build. The US equity bull market may last a bit longer on momentum in new orders on the back of backlogs in inventory restocking but it is hard to see a broad based recovery based on internal consumption. The US bull market is unlikely to persist more than a further 3 to 6 months. How you trade it, is a matter of personal trading style.