

Is It Time To Buy China? Worry About the US.

Markets were badly shaken again this week. The trading was interrupted by a US holiday as the nation paid its respects to the late President George HW Bush. The stock rally that was triggered by an apparent change of pace of the Fed, and a temporary ceasefire on the trade front at the G20 meeting, gave way to concerns that the truce would be short lived and inconclusive. Daily market volatility has been elevated. Index moves under-represent the degree of uncertainty at the stock level. Credit spreads have re-widened to year highs.

What is going on? The global economy is undoubtedly slowing, perhaps excepting the US which is still growing robustly. NAPM manufacturing and non-manufacturing PMIs remain well north of 50 and are not decelerating. The trade balance is worsening, surely a sign of strength in the domestic economy. Outside the US, in Europe for example, the economy is quite evidently slowing. Weakened consumer sentiment and trade are to blame. The trade woes predate the trade war and are part of a longer term trend. In China, the economy is also slowing quite apparently and the PBOC appears bent on deleveraging rather than arresting the deceleration. And yet, growth in Europe is still positive, 1.7%, and growth in China is 6.5%, perhaps slowing to 6.2% next year, hardly slow, and hardly a recession.

The economic recovery is nearly 9 years old, with some interruptions in Europe and China. Its been a long time. A diet of QE has stabilized the economy and prolonged the cycle. A prescription of financial system regulation, the recapitalization of banks and the deleveraging of the shadow banks, has stabilized and strengthened the financial infrastructure. The cycle was due to turn, but it would be a shallow cycle.

The problem was that asset prices ran ahead of themselves. Reality is not bad, but markets priced in a reality that was great and forever. With such expectations, all it takes is a few disappointments for sentiment to get ugly.

Let's look at the reality in China.

Growth is slowing, no doubt, but the quality of that growth is improving. China is becoming less unbalanced, relying more on consumption and internal technological innovation; it has become the largest patent filer in the world, overtaking the US, Japan and Germany. Technology and innovation are supported by government, this is one area of contention with America, but ask who funded US technological innovation during the post war years and the Cold War (with Russia.) The middle class is growing with more urbanization and higher incomes; one of the reasons for rising costs is rising wages. Private consumption is now 39% of GDP, low by international standards, but high when adjusted for the high savings rate.

The primary driver of stock market returns, and the economy, is policy. China is deleveraging in reaction to an earlier infusion of leverage which it used to stabilize the economy post the financial crisis. Yes, China was doing QE. You could say that since 2015, China was normalizing policy. One could draw examples of what could happen as the US normalization ages and how it could impact markets. On the fiscal front, China is cutting taxes and introducing deductibles for the first time (Jan 2019) which should give consumption a boost. Corporate tax cuts have been signaled for later 2019. As China deleverages, it does so mostly in the shadow banking system while compensating by capitalizing and providing liquidity to the regulated banking system. It's just good risk management.

The trade war is hurting China, yes, but China's dependency on trade has fallen in the last decade as part of an intentional effort to balance the economy. While the US remains its largest trading partner gross exports to the US constituted

just 4% of total China GDP in 2017, down from 8% in 2008. The trouble with this trade war is that its not just about trade but about hegemony and supremacy.

Were equity valuations as high as in the US, one might worry, but the S&P trades on 16X earnings while Chinese stocks trade around 11X earnings. US earnings growth is likely to lag China's by 9% vs 12% according to the consensus on Bloomberg. China has been normalizing QE for over 3 years whereas the US is only in its first year. One country is building walls, while the other builds bridges.