Q&A: China's Investibility

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Anyone trying to keep up with the news flow out of China over the last few months has been made to feel like Lewis Carroll's rabbit. From the pulling of Ant Group's IPO to the Ningbo port shutdown, from the crushing of Didi Global's IPO to the China Evergrande debacle, from the public execution of education stocks to July's cut in reserve requirement ratios, it seems every week has brought developments that have forced investors to re-calibrate their assumptions about the Middle Kingdom.

Against this rapidly changing backdrop, the default mode among most investors seems to be:

1) To infer that Xi Jinping is a Mao Zedong wannabe, a power-mad dictator who will brook no dissent, and who will chop off any heads that stick out.

2) To conclude as a result that China is now uninvestible.

Even if they do not buy Chinese assets, investors can no longer ignore China

This simplistic view still leaves investors in a quandary: how will China affect other economies and markets over the coming year? In the Mao era, investors could afford to ignore China, which was about as relevant to global economic activity and financial markets as North Korea is today. This is no longer the case. China is now the world's second largest economy and the largest trade partner for most major emerging markets as well as a good many developed markets. Ignoring China is no longer an option.

Over the last few weeks, the Gavekal and Dragonomics teams and I have spent a good deal of time on zoom calls and email, discussing recent events in China with clients. What follows is a distillation of those conversations.

Is Evergrande China's Lehman moment?

This was the question we addressed in last week's Gavekal seminar (see **The Evergrande Crisis**). The answer was a firm no.

The first important difference between Evergrande and Lehman is that the US government was trying to save Lehman, so when Hank Paulson's "bazooka" turned out to be a dud, investors panicked. In contrast, the Chinese government has been trying to take Evergrande down.

Unlike the US in 2008, it's not China's entire financial system that's in trouble

The second difference is that although we remember 2008 as the Lehman crisis, many other large US institutions were also facing major problems. Merrill Lynch was merged into Bank of America. Wachovia merged into Citibank. AIG was bailed out. Morgan Stanley and Goldman Sachs had to transform themselves into commercial banks. In short, the Lehman crisis was not about Lehman only. The entire US financial system collapsed.

So far, the contagion from Evergrande's likely collapse—the company's US dollar bonds have been trading below 35 cents on the dollar for a few weeks now—remains limited.

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Only a handful of Chinese property developers are officially cut off from new credit

Ticker	2020			1H21			Change (HoH)	
	Liabilities/ assets	Cash/short term debt	Net gearing	Liabilities/ assets	Cash/short term debt	Net gearing	Total debt	Net debt
GUOPRO	72.5%	0.20	143%	71.6%	0.29	129%	-6.0%	-8%
GZRFPR	76.7%	0.40	130%	74.9%	0.25	123%	-10.3%	-4%
EVERRE	83.4%	0.47	153%	81.0%	0.36	100%	-20.2%	-23%
GRNLGR	84.1%	0.79	137%	82.8%	1.05	120%	-9.2%	-6%
SINHLD	73.2%	0.78	64%	73.5%	1.10	51%	-0.3%	-16%
CAPG	78.9%	1.00	83%	78.9%	1.17	77%	-3.1%	-8%
CENCHI	85.5%	1.48	14%	87.2%	1.28	93%	-9.6%	498%
CIFIHG	72.5%	2.73	64%	72.1%	2.67	60%	5.8%	6%
COGARD	80.5%	1.74	56%	78.5%	1.93	50%	-0.7%	-3%
DAFAPG	68.6%	0.76	61%	69.0%	0.85	56%	-2.8%	-4%
DEXICN	74.2%	1.68	75%	73.6%	1.28	72%	15.1%	16%
FTHDGR	72.4%	1.37	75%	72.7%	1.40	75%	9.9%	9%
FUTLAN	76.2%	1.89	51%	76.9%	1.59	65%	9.4%	39%
GRNCH	71.9%	1.83	64%	73.5%	1.87	75%	7.3%	15%
GWTH	67.8%	0.28	96%	67.6%	0.22	82%	-2.9%	-16%
JIAZHO	79.8%	1.04	97%	78.6%	1.04	95%	-4.2%	5%
JINGRU	80.1%	1.19	69%	80.1%	1.34	81%	8.3%	15%
KWGPRO	75.1%	1.61	62%	71.8%	1.81	54%	3.8%	1%
LANDSEA	77.5%	5.99	24%	73.8%	2.69	51%	7.9%	141%
LVGEM	61.8%	0.26	76%	62.4%	0.50	78%	-0.1%	5%
MOLAND	82.0%	1.10	96%	83.0%	1.46	93%	16.9%	8%
REDPRO	78.1%	1.44	49%	77.7%	1.31	51%	14.2%	20%
RISSUN	73.8%	1.09	80%	71.9%	1.05	66%	-7.1%	-7%
SUNAC	78.7%	1.08	96%	76.5%	1.11	87%	0.0%	6%
SUNSHI	79.1%	1.06	95%	78.8%	1.27	94%	-10.1%	-4%
TPHL	78.6%	1.76	68%	76.6%	1.90	71%	-10.8%	18%
YUZHOU	77.9%	1.68	86%	74.0%	1.70	80%	-5.8%	9%
ZHLGHD	79.9%	1.10	66%	79.3%	1.22	56%	0.9%	-4%
ZHPRHK	76.6%	1.81	73%	72.4%	1.72	64%	5.8%	9%
AGILE	72.3%	1.09	61%	68.8%	1.18	45%	0.1%	-11%
JINKE	70.2%	1.27	75%	69.3%	1.32	75%	-3.9%	8%
KAISAG	70.1%	1.56	94%	69.9%	1.53	92%	1.9%	1%
CHINSC	68.7%	1.33	59%	69.5%	1.23	78%	8.6%	33%
GEMDAL	68.5%	1.29	60%	69.4%	1.31	70%	14.6%	19%
HPDLF	64.4%	1.56	80%	63.2%	1.45	66%	7.3%	-7%
JIAYUA	67.8%	1.27	60%	62.2%	1.29	41%	7.0%	2%
JNHUIG	69.0%	1.07	75%	68.3%	1.07	76%	1.2%	6%
LOGPH	69.8%	1.28	71%	69.0%	1.39	70%	6.0%	13%
REDSUN	69.4%	1.09	50%	69.4%	1.34	54%	4.9%	18%
RONXIN	69.9%	1.08	83%	69.7%	1.09	75%	0.1%	-5%
SHIMAO	68.5%	1.67	50%	68.3%	1.68	50%	13.3%	7%
YLLGSP	66.9%	1.83	66%	66.4%	2.76	50%	-1.2%	-22%

Nomura

Allowed zero debt growth · Allowed 5% debt growth · Allowed 10% debt growth · Allowed 15% debt growth

Only a few Chinese property developers have crossed all of Beijing's red lines

Sure, China's other leveraged developers are hardly sitting comfortably right now. But how many are on the edge of the precipice? In 2019, Chinese regulators drew three red lines, telling banks not to lend more to developers whose adjusted liabilities-to-assets, net debt-to-equity and unrestricted-cash-to-short-term-debt ratios crossed those red lines. At the end of 2020, only three companies aside from Evergrande crossed all three red lines, and have since been cut off from further balance sheet expansion: Guangzhou R&F Properties, Greenland Holdings and Guorui Properties (with a relatively small market cap of US$180mn). China's other property developers can still access credit lines, at least in theory (in the table, developers in blue are allowed 15% growth in debt; green, 10%; orange, 5%; and red, zero).

This is not to say that the crackdown on Evergrande will have no economic impact. It will. But the point is that investors should not assume a systemic meltdown of China's banking system must follow.

Instead of being too big to fail, Chinese companies want to be small enough to fly under the radar

On the contrary, one likely impact of the Evergrande debacle, together with the crackdown on Alibaba, Didi and the rest, is that the days when the default business model in China was a race to achieve "too big to fail" stature are now over. Chinese entrepreneurs must adjust to a new regulatory environment: one in which the new goal is to be small enough to fly under the regulators' radar. So, not only are China's days of adding excess labor to the global workforce over, this shift means the days of China adding excess production capacity are now over too. As regulation forces Chinese businesses to change their stripes, China's deflationary impulse on the world will continue to abate.

So while Lehman was a profound deflationary shock for the world, it is not obvious that Evergrande will be similarly deflationary. In line with the old adage that crises tend to accentuate underlying trends, it may well turn out that Evergrande ends up being an inflationary shock for the world, with far less excess supply coming out of China.

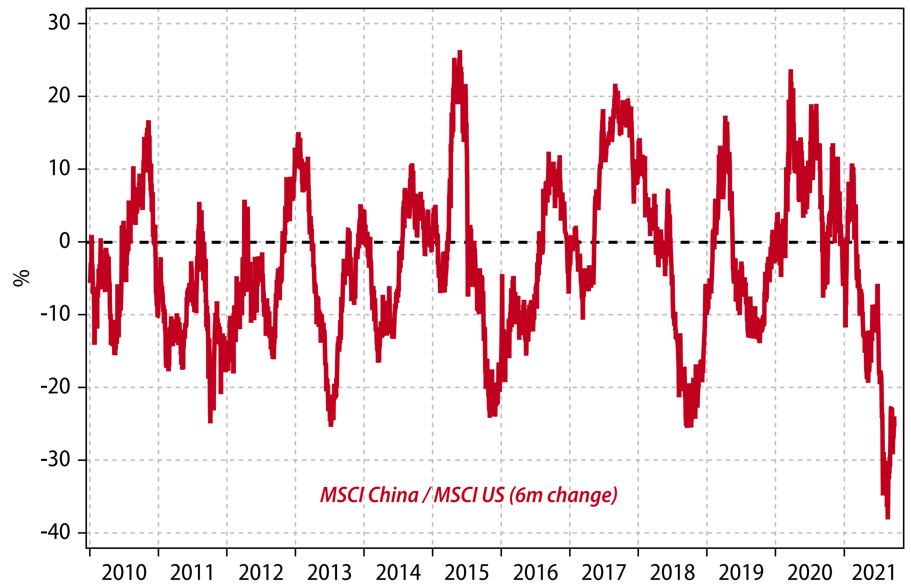
But don't you find this string of corporate takedowns scary?

Investors fear government interference will lead to capital misallocation

I take your point that the Chinese government has deliberately gone after overleveraged developers headed by Evergrande. But don't you find this scary? Following Alibaba, Didi, the education stocks, the gaming stocks, and Evergrande, China today feels like a Freddy Krueger movie: you wonder who's next. Sitting 10,000 miles away, it increasingly feels as if Xi Jinping is a wannabe Mao. Why shouldn't I worry that China is slipping back into a communist hell-hole of misallocated land, labor and capital?

I know I overuse this line from Steve Martin, but before we criticize someone, we should walk a mile in his shoes. That way, when we do criticize him, we are a mile away and we have his shoes.

As you point out, Chinese equity investors have just taken a massive beating. Over the last six months, Chinese stocks have underperformed the MSCI World by -40pp. This is the worst underperformance in a decade. It is even worse than the underperformance during the 2015 Shanghai crash.



Having endured such a beating, it is only natural for investors to ask "who did this to me?" And when the lights go on, sure enough, there's Xi standing over them wearing a pair of boxing gloves. So, how could China's policymakers be so callous to impose such large losses on the holders of Chinese risk assets?

For Xi, the big event was the US assault on Huawei

For Xi, it is likely the most traumatic and humiliating event of recent years was not Covid, nor China Huarong, Baoshang Bank or even Evergrande. Instead, it was when China's policymakers had to watch impotently as the US government put Huawei to the sword (see **A Death Sentence For Huawei**).

The evolution of US-China relations from trade war to tech war (see ***Clash Of Empires***) forced Beijing to confront China's own weaknesses, and to accept that while hoping for the best might make sense, it had little choice but to plan for the worst. This meant addressing China's three main vulnerabilities:

1) **China's dependence on imported semiconductors**. China spends roughly US$30bn per month on semiconductor imports, more than it spends on imports of anything else, including crude oil. And it was by restricting semiconductor exports to China that Donald Trump brought Huawei to its knees. So perhaps it is no surprise that China's industrial policy is focused on producing its own semiconductors.

   Beijing's crackdown on China's internet sector has to be understood in this context. The message is that it might have been all right for the country's best and brightest to work at developing the next generation of video games, or at finding better ways to insert advertisements into online cat videos, when the US was not trying to bring down the Chinese economy. But given the shift in global sentiment against China, Chinese tech companies now have to do their part for national service.

In strategic terms, China's biggest internet platforms are surplus to requirements

   Tensions over Taiwan are linked to this tech war. Now that Taiwan Semiconductor Manufacturing Co. has leapfrogged Intel to produce the world's most advanced chips, Taiwan is an obvious target for attention.

China's peak carbon plans will help to sever its dependence on imported energy

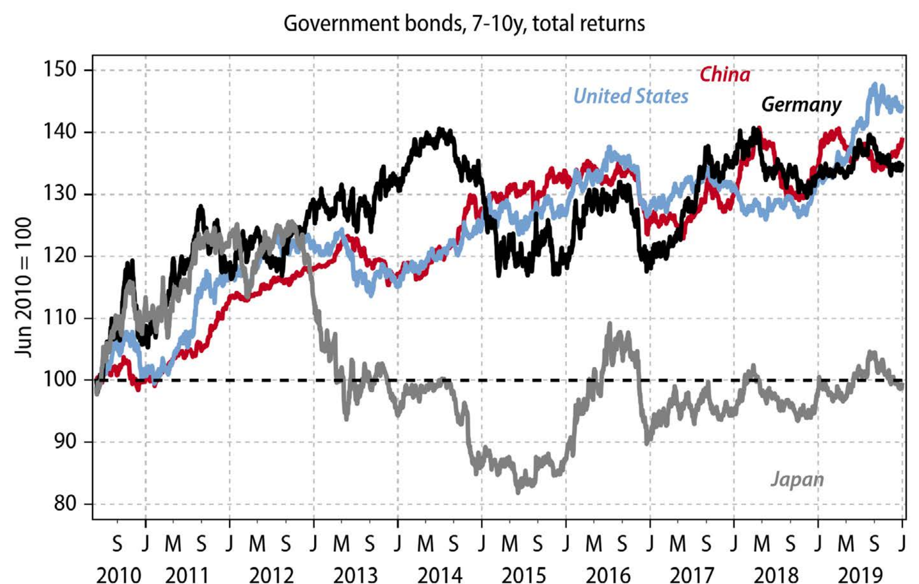
2) **China's dependence on foreign energy**. China imports almost 10mn barrels of oil per day—at US$80/bbl, that's an annual import bill of US$290bn—along with coal and natural gas. Most of these imports are seaborne. This leaves China vulnerable. To address this, China is keen to move away from carbon-energy as rapidly as possible. Cue the push towards electric vehicles and the pledge to reach peak carbon by 2030. But it is also keen to develop a blue-water navy, complete with friendly ports along its import routes—in Sri Lanka, Myanmar, Pakistan. And it is deploying capital into constructing pipelines, whether from the Pakistani port of Gwadar, from Russia, or from Kazakhstan across Xinjiang.

   On this note, what should we think of the sudden Western interest in the plight of China's Uighurs, and the relative silence on the similar plight of the Tibetans? Is it because as China's economic interests in Xinjiang increase, so does the Han population, which creates a backlash from the local minorities, which in turn leads to the repression documented by the Western media? Or it is that Western media interest in the plight of the Uighurs has increased in parallel with the construction of China's pipelines, and its dreams of importing energy overland?

US enemies find they cannot settle their foreign trade in dollars

3) **China's dependence on the US dollar**. In recent years, the US has weaponized the US dollar. Countries including Iran, Venezuela and Sudan have found themselves unable to settle their foreign trade in dollars. Of course, a decision by the US to block China's access to US dollar funding would trigger an economic cataclysm even greater than the 2008 mortgage crisis, which makes such a decision highly unlikely. Still, Chinese policymakers cannot afford to remain dependent on the willingness—or the ability—of western banks to finance China's trade. Following Huawei, China has no choice but to reduce its dependence on the US dollar. That means China has little choice but to try and transform the renminbi into a credible trade and reserve currency in its own right.

CGBs outperformed over the decade before the pandemic



To do this, the renminbi has to be a strong currency, which it has been—over the past three, five and 10 years, the renminbi has outperformed all other major currencies. And the Chinese bond market has to be a credible safe haven for foreign savings, which it has been since China started to open up the market to foreigners a decade ago.

All this may help to explain why, while the west embraced unprecedented monetary and fiscal policies in response to Covid, Chinese policymakers by and large sat on their hands.

This brings us to Evergrande. Counterintuitively amid the debacle in Chinese equity markets, the fears that China is facing a Lehman moment, the concerns that Chinese growth is slowing, and the widespread belief that Xi is a new Mao, so far this year the renminbi has strengthened from CNY6.52 to the US dollar to CNY6.46. And even as the fears have intensified, the renminbi continues to trade above its 200-day moving average against the US dollar.

Despite all the fears about China, the renminbi has held up

Gavekal Research/Macrobond

CGBs have outperformed through the pandemic

Gavekal Research/Macrobond

Just as importantly, while global investors are fretting that the Chinese financial system is set to implode, Chinese government bonds are outperforming almost every other major government bond market year to date. Even more impressively, since mid-August when concerns about Evergrande started to make headlines, Chinese government bonds have delivered positive returns, while bonds in the US, Germany and Japan have all delivered losses.

So how could CGBs and the renminbi deliver such outperformance in the face of growing concerns that the looming bankruptcy of Evergrande is China's Lehman moment?

The simplest answer is that the idea that Evergrande is China's Lehman moment is a gross exaggeration of a less dangerous situation. Sure, Evergrande is a problem, and Chinese real estate activity and overall economic growth will take a hit over the coming months. But Evergrande is hardly the systemic crisis so many apocalyptic commentators are making out.

Another answer is that when dealing with overleveraged and financially stressed property developers, policymakers have a choice. They can:

1) Launch a massive bailout. Following Lehman, this is what western investors have come to expect from their own policymakers. The view is that to avoid spillovers and contagion, central banks should print money and governments spend it. Long term consequences—falling currencies, accelerating inflation, rising wealth inequality—can be dealt with later. As John Maynard Keynes said, "in the long run, we are all dead."
2) Take the pain up front. Let the overstretched go bankrupt, if only *pour encourager les autres* to keep their own financial houses in order.

In the past, Chinese companies had every incentive to become too big to fail

In the past, China tended to favor the first solution. In 2003, 2008, 2015, whenever uncertainty prevailed the politburo had no qualms about leaning on China's banks to lend to struggling companies, municipalities, and provinces. This encouraged Chinese companies to embrace a too-big-to-fail view of capital spending. They made investments not because they would be profitable, but because being bigger was a guarantee they would survive the next downturn.

But the times they are a-changin'. Evergrande demonstrates that Chinese policymakers will no longer automatically ride to the rescue of those who lean too far over their skis. This may be for geostrategic reasons: China needs a strong currency and a stable government bond market, and repeated bailouts would undermine the credibility that China is working so hard to achieve. Or it may be that the too-big-to-fail business model risks disrupting social harmony or common prosperity. Or it may be that Chinese policymakers are worried about the world's accelerating inflationary trends. If so, are Chinese policymakers telling us that "Keynes is dead, and this is the long run"?

Xi wants to overcome China's structural dependences

The bottom line is that if you accept the premise that "just because you are paranoid doesn't mean they aren't out to get you", then perhaps the explanation for Xi's behavior is not that he believes himself to be a 21st century Mao, but that he is attempting to address China's three structural weaknesses. In other words, different times throw up different challenges, which require different responses. To say Xi wants to be another Mao is a lazy shortcut.

Surely China and the west can work together on some issues?

I get how US pressure has driven Xi's desire to allocate human and capital resources away from the internet sector towards China's domestic hardware industry. But surely his climate goals show that China and the US can still work together on some issues? So, the geopolitical situation may not be as bleak as most see it?

There are many ways to look at China's shift on carbon.

- China, acknowledging that green issues matter to the US and other developed economies, is showing a willingness to compromise and to adopt tough green constraints on its economy in a bid to restore strained relations with the west.
- Xi is simply bending policy towards his domestic needs. As China's urban middle class continues to grow, calls for cleaner air, cleaner water, and a less polluted environment grow ever louder.

- With one of the highest population densities in the world along its coast, China could be one of the biggest victims of global climate change. And in China's history, emperors who suffered major natural disasters were often thought to have lost the "mandate of heaven".
- As we have seen, one of China's biggest economic vulnerabilities is that it imports 10mn bpd of oil along sealanes dominated by the US navy. In a world where the US is growing ever more skeptical about China, this is an uncomfortable situation.

China's peak carbon ambitions will force a change in business models...

Regardless of the main driver behind China's decision to aim for peak carbon by 2030, what matters is that the decision is now inscribed as government policy. Yes, policymakers all over the world have similar lofty goals. What sets China apart is that its leaders have a track record of "saying what they do, and doing what they say". When Xi declares that China's economy must reach peak carbon by 2030, his declaration will have a big impact on decisionmaking across all levels of the Chinese government. With "peak carbon 2030", China's business model is changing in front of our eyes, with deep consequences for many industries.

For example, if China is going to reach peak carbon by 2030, does it make sense for Saudi Aramco or Exxon to drill new oil wells? Probably not. But if big oil companies do not drill new wells, doesn't this guarantee that the current energy shortages (see **Investing In Today's Inflationary Environment**) will last much longer than most people now believe?

...eliminating the incentive to invest in excess industrial capacity

Or take steel, aluminum, petrochemicals, shipbuilding, or any other energy-intensive industry. For years China pursued a strategy of global domination in these industries, even though its only real comparative advantage was its ability to pump large amounts of disgusting pollution into its atmosphere or water. So China would import tons of iron ore and tons of coking coal in order to produce steel for export. Will this continue in a "peak carbon 2030" world? Probably not. But if not, where will the world's excess steel, aluminum, petrochemicals and ships come from to help keep global prices in check?

So, while western policymakers may rejoice today at China's peak carbon ambitions, they may want to be careful what they wish for. Whether or not China's peak carbon plans help to solve climate change, they are likely to make the current age of shortages more acute.

Doesn't that mean China's growth will slow further?

Yes. Like everywhere else, China will face a trade-off between growth and green policies. Otherwise, government-imposed constraints involved in the adoption of green policies would not be necessary; the market would get there on its own. So yes, by adopting peak carbon, Beijing is signaling to the world that China's growth rate, and especially China's excess capital spending in carbon-intensive industries, will roll over. The upshot will be less growth and more shortages.

Won't slower growth threaten Xi's grip on power?

If China's growth slows, isn't there a risk of social instability? Is there are a chance the current leadership will lose its hold on power?

The view that the Chinese leadership will lose its grip on power should a real economic slowdown strike is odd, historically incorrect, and likely archaic.

Investors don't worry that slow growth in Europe will lead to the overthrow of the system

It is odd because while this is an argument people often make about China, they seldom make it about anywhere else. Do investors fret about an implosion of the European Union because growth has been lethargic for two decades? Do people worry that a recession will topple Vladimir Putin, Jair Bolsanero, or Narendra Modi? No. But this remains a constant belief about China.

The reason may be a misreading of China's history. Most westerners assume that because China's leadership does not derive its legitimacy from the ballot box, the Communist Party's legitimacy is tied up with its ability to deliver the economic goods. In this view, so long as there is rapid growth, people will put up with the Party's rule. But if growth disappears, so will the Party's legitimacy, and its tenuous hold on political power.

In China, the premium is on social stability, not economic growth

This simplistic view is inaccurate, because the source of the Communist Party's legitimacy is not its ability to deliver economic growth, but its ability to deliver social stability. Given China's history, social stability comes at a huge premium. Between the start of the Taiping Rebellion in 1850 and the end of the Cultural Revolution in 1976, China knew little but famine, civil war, foreign invasions and hyperinflation.

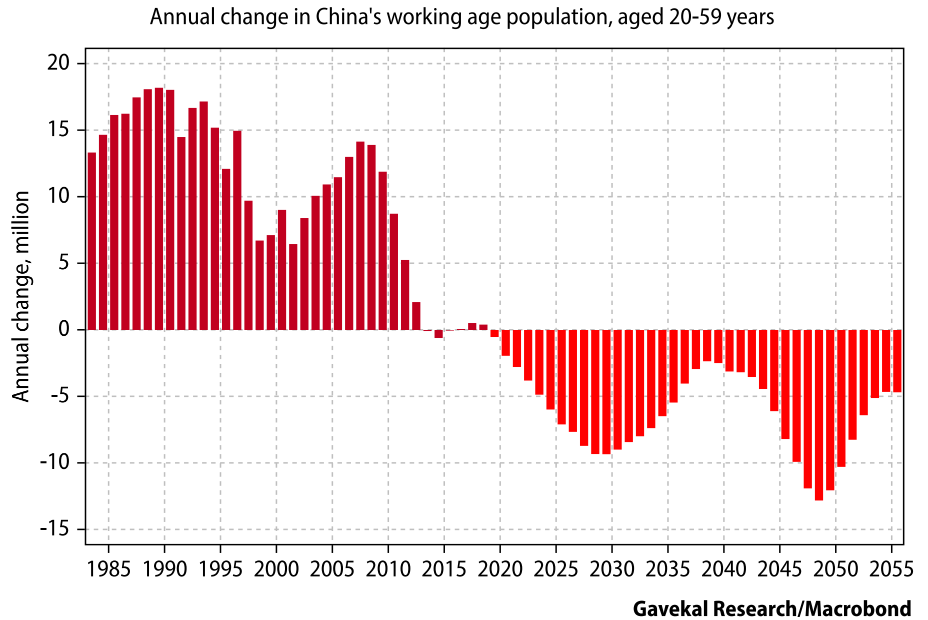
For generations China was among the hardest places in the world to live, which explains why so many Chinese left to work as quasi-slaves building railroads in the US or Canada, or working in plantations across South East Asia. It also explains why, when in 1998-99 China launched a tough restructuring of its state-owned enterprises, shedding more than 30mn industrial workers, social tensions never threatened the regime.

China's aging population is not about to rise up against the Party

Finally, the view that the Party's rule is dependent on rapid economic growth appears archaic. If Chinese citizens did not riot in the late 1990s, they are far less likely to riot today, for the simple reason that the Chinese population is much older today than it was two decades ago, and throwing stones at the police is a youngster's game. Moreover, China's young are almost all single children. If trouble kicks off in the streets, parents will waste no time grabbing their children and dragging them back inside.

This brings us to something that has gone largely overlooked among all the developments of the last year: the release of China's latest census. This highlighted two important trends. First, China is aging faster than previously thought, with birthrates lower than expected. The second is that China has been urbanizing much faster than previously thought (see **The Population Turning Point Gets Closer**).

A decade ago, 15-20mn Chinese left the countryside each year in search of work in the cities. The old rule of thumb was that 8% GDP growth would deliver 20mn new jobs, hence the sacrosanct old growth target of 8%. Now, the Chinese workforce is shrinking, and will continue to do so for years.



The days of growth at all costs are now over...

This contraction will have deep consequences. First, with fewer workers, China's GDP growth will naturally slow. Second, with fewer workers joining the economy, the Chinese government no longer needs to pursue growth-at-all-costs policies. Third, if Chinese workers now become more scarce instead of being plentiful, China will be less of a deflationary force for the world.

But right now, isn't Evergrande a major deflationary shock?

Maybe over the long term China will become less of a deflationary influence. But for now, aren't we looking at a major deflationary shock in the shape of the Evergrande bust?

There is still a lot of uncertainty about how the Evergrande drama will play out. But it is probably not too early to take away a few lessons. The first, and perhaps the most important, is that the days of businesses following the too-big-to-fail approach to capital spending are probably over.

...so are the old days of too big to fail for China's businesses

For two decades following the massive restructuring of SOEs in the late-1990s, the message taken away by chief executive officers and entrepreneurs was that their business should grow as big as possible, as quickly as possible. That way, when the downturn came, their companies would be the ones which would get access to bank credit. And it would be their companies that would get to take over smaller rivals, instead of getting taken over. So the purpose of investment, instead of being to boost productivity, became to get big.

In the last few years, China's policymakers have tried to change this attitude. Now, it seems likely that 2021 will go down as the year when the too-big-to-fail mentality finally died. After Alibaba, Didi, TAL and New Education—and of course of Evergrande—the growing feeling among Chinese entrepreneurs and business executives is that small is beautiful. All of a sudden, avoiding the Communist Party's radar is the main concern of most corporate leaders, a 180-degree reversal from the recent past.

The timing of the government's attack on the too-big-to-fail business model is probably not a coincidence. As we've seen, 10 years ago the government's key concern was to generate employment for the 20mn workers leaving the countryside each year for the cities. This meant the government did not mind much if companies overinvested. Sure, overinvestment meant constrained margins for everyone and a lack of pricing power for Chinese businesses on the global market. But the overinvestment helped to create jobs at a time when jobs were needed.

With job creation no longer so important, capital spending on excess capacity is now frowned upon

Today, jobs are no longer needed as they used to be. This means there is no longer any reason to countenance capital-destroying and margin-compressing excessive capital spending. This brings us back to Evergrande, and why the government doesn't seem to be feeling any sense of urgency about dealing with a situation its own policies helped to create.

So yes, Evergrande's likely bankruptcy will cast a long shadow. Wealth management products will take a hit. This will constrain lending to the construction sector, which will continue to slow, dragging down China's GDP growth. But, is this a design flaw of Chinese policy, or a design feature?

What should the world make of a China that invests less, where companies are incentivized to stay below the radar rather than to grow rapidly by adding excess capacity, and where labor, instead of being abundant, now becomes scarce? All this points towards a macro shift away from the "age of plenty" to "an age of scarcity" (see **Investing In Today's Inflationary Environment**).

China's coal prices have shot through the roof

If you are inclined to doubt all this, take a look at the chart below, which is probably the scariest in China today. At a time when China is attempting to crack down on carbon emissions, when Chinese economic growth is visibly slowing, when the Chinese real estate sector is hitting the skids, why has the price of coal in China surged to an eight-year high? If Evergrande is such a deflationary shock, why is this happening?

Does this look like a deflationary shock?

Is it because China is about to scrap its zero-Covid policy?

Is the coal price rising because the market is anticipating that China will abandon its zero-Covid policy? In recent years Chinese policymakers haven't scored many own-goals. But continuing the current zero-Covid approach while Europe and the US reopen appears to be an own-goal of epic proportions. Surely, China's leaders will soon scrap this policy? And when they do, won't reopening plays like Macau, tourism, and luxury goods rip higher, along with cyclicals everywhere?

In the Communist Party's book, its Covid response has been a resounding success

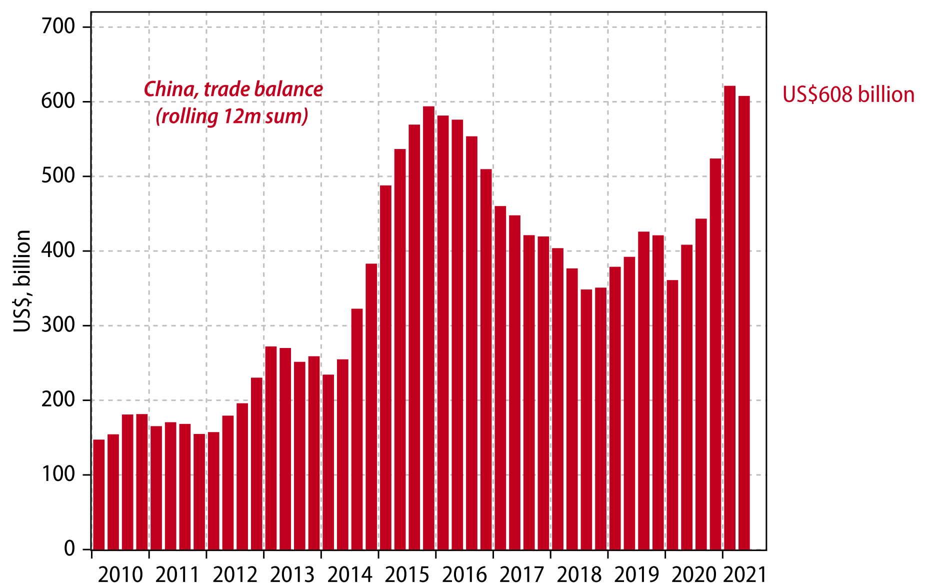
I am not sure about that. As far as Chinese policymakers are concerned, their Covid policies have been a resounding success. This might sound odd to someone who can now fly from Paris to Miami, or from London to New York and largely live life as it used to be. Nevertheless, the prevalent rhetoric in China is that the west's relative freedom has come at a cost of millions of lives. Today, the Communist Party is congratulating itself on the back for a job well done over its handling of Covid.

Part of the reason the Party is patting itself on the back is that the economic impact of domestic lockdowns has been mitigated by the strength of the Chinese trade picture. And this strength is due in no small measure to the collapse in China's tourism imports. The millions of Chinese people who in recent years went abroad to buy Gucci shoes in Milan, Hermes bags in Paris, or to experience fine dining in Tokyo have all been stuck at home. In a society now focused on "common prosperity", is this a flaw in government policy? Or is it a hoped-for feature?

China's trade surplus has hit new highs

In a world where global trade has collapsed, China's own trade surplus has been breaking out to new highs. This helps to keep the renminbi strong. And as we've seen, a strong renminbi is a necessary condition for China to gradually shift more of its trade away from the US dollar.

So much for the trade war



Gavekal Research/Macrobond

So, there doesn't appear any rush among China's policymakers to abandon their zero-Covid policies. If nothing else, reopening China's borders might encourage capital outflows, a sharp rebound in conspicuous consumption, and increased social tensions, all things currently in the leadership's gunsights.

Beijing has an eye on the winter Olympics

Moreover, looking at the calendar there are two key dates coming up. The first is the winter Olympics that kick off on February 4th, 2022 in Beijing. As far as the Communist Party is concerned, the worst possible optics would be to start the Olympics with hospitals around the country overflowing. It therefore seems likely that any loosening of Covid restrictions will only occur after the games, in the spring of next year at the earliest

The second big event will be the 20th Party Congress in October 2022 which is almost certain to see Xi secure an unprecedented third term. Again, the last thing the party will want before the Congress will be for its propaganda about how it has managed the Covid outbreak more efficiently than any other country to come under scrutiny. This suggests two possible paths.

Xi may declare victory over Covid in 2022

1) Europe and the US have a relatively benign winter. Vaccines help to prevent severe illness, and treatments for patients that do get sick have greatly improved. As a result Europe and the US suffer few Covid deaths. In this scenario, China can start reopening in the late spring or early summer and at the Party Congress Xi can declare victory against Covid.
2) Europe and the US have a bad winter. China continues on its zero-Covid path. And at the Party Congress, Xi declares that China has done a much better job than western countries of protecting its population.

So, I would not rush to assume that China is set to reopen any day now. Unless economic activity really tanks, it seems likely that China is still at least six months away from relaxing its zero-Covid policies.

What's behind the review of Macau's gambling licenses?

You mentioned Macau. What is behind the Chinese government's review of Macau's gambling licenses? After education, fintech, ride-sharing and food delivery, is the Communist Party also trying to make gambling uninvestible?

Investors did not wait for details before unloading Macau casino stocks

This is a head-scratcher. After what happened to Alibaba, Didi and education stocks, Chinese equity investors are clearly traumatized and likely to adopt a sell-first-ask-questions-later attitude. So, as we saw in late September, one negative headline on Macau and the stocks collapsed. And then you got the usual feedback loop, with the markets making the news, rather the news making the markets.

The key question behind the review of the casino licenses is whether the central government can afford to crush Macau's economy as it crushed the education sector. Because, without gambling, Macau is just another sleepy town in Southern China.

In this sense, Macau has always been an anomaly. Why would the righteous, or at least self-righteous, Communist Party allow such a den of iniquity complete with gambling and prostitution to operate within China's borders? And why would it allow a meaningful portion of the profits generated to flow to the US through Las Vegas Sands, Wynn Resorts, and MGM Resorts?

Surely the Party has to get something out of Macau's existence beyond the jobs created in Macau? This is where things get complicated.

These days, one country, two systems has little attraction for the Taiwanese

The first benefit the Party reaped by turning a blind eye to Macau as sin city was a boost to the credibility of the one-country-two-systems model of governance. This mattered because the promise of one country, two systems was a play to bring Taiwan into the fold. Unfortunately for Macau, the necessity of keeping up appearances over one country, two systems has been shot to pieces by developments over the last two years in Hong Kong. The idea that China will be able to entice Taiwan into unification with the motherland by holding up Hong Kong as an example now seems far-fetched.

The second benefit for the Party was that Macau allowed corrupt officials and businessmen to recycle their dirty money. This was a necessary evil, because otherwise there was a risk all the dirty cash in China would have languished in shoe boxes at the bottom of closets instead of getting reinvested in the economy and helping to generate growth. However, as China starts to shift towards a digital currency, there will be less dirty money to recycle. And in a world where there is no more dirty money to recycle, why should the Party accept casinos with all their negative effects?

US casino companies' political donations were handy for Beijing

A third potential benefit is the extent to which US casino-owners have become large donors to US political parties, especially the GOP. As a result, the voices of casino owners have gotten heard in Washington. To some extent this gave China a back channel to pass messages to US politicians. However, this back channel clearly broke down under Trump. This raises the question whether it still makes sense for China to let US casino-owners make a ton of money out of Chinese punters, if those casino-owners can no longer provide a useful back-channel into Washington's circles of power.

Finally, for years Macao was a safety valve, allowing capital to flow out of China when the upward pressures on the renminbi got too great. When Beijing got worried about downward pressure on the currency, it would restrict visas to Macau. When it was concerned about upward pressure, it would grant more visas. Today, Beijing is no longer so worried about renminbi strength. On the contrary, one of the big lessons of the last year is that it wants a strong currency. In any event, should Beijing want to push capital abroad, it now has more productive ways to do so (see **Completing The Bond Connection**).

All this points to three potential scenarios:

The Party may decide the costs of allowing gambling outweigh the benefits

1) The Party decides the social costs of gambling now outweigh its benefits. Licenses are not renewed. One downside is that this would trigger an implosion of Macanese growth, and possibly social unrest in the territory. Another downside is that gambling would just move underground, controlled by triads, who would be given a new lease on life. Cue a big rise in crime (in the late 1990s, Macau had battles on its streets between gangs using automatic weapons), and more corruption.
2) Licenses for locally-owned casinos get renewed. Foreigners get frozen out. Cue a rally in local gambling names and big hits for US operators.
3) The *status quo* prevails. All the licenses are renewed, and Macau booms as Covid travel restrictions are relaxed.

Clearly, owning foreign casinos is a bet on the third scenario. Owning local casinos is a bet on either the second or the third. It's not difficult to work out which group has the more attractive risk-reward profile.

What should we make of "common prosperity"?

The attack on gambling, on education stocks, on internet platforms, the take-down of Evergrande: each of these actions has led to another leg down in the prices of Chinese equities. Rather than accept that they have made a mistake, China's leaders seem intent on doubling down by hiding behind the smoke-screen of the so-called "common prosperity" imperative. What should I make of this? Is common prosperity like motherhood and apple pie: something no politician can be against? Or is there more at play here?

Common prosperity remains an abstract slogan...

This is a tough question. I am not sure there are any clear answers, or at least not yet. For all the talk of common prosperity, we have yet to see any party directives or set policy goals crystallizing this lofty aspiration. So I am somewhat sympathetic to the idea that common prosperity is akin to motherhood and apple pie.

If you were cynical, you might conclude that the vagueness of common prosperity is not a bug of the policy, but its principal feature. This vagueness allows Xi and the politburo to go after any behavior, company or individual they deem to be out of line with their common prosperity goals. That's handy.

Beyond that, the real question for me is whether the true target audience for all the common prosperity propaganda is domestic or foreign.

...but it differentiates China from the west...

Common prosperity is a way for the Chinese government to highlight the differences between policymaking in China and in the west, not just to China's citizens but also to citizens of the developing world in general. The not so-subtle message is that while policymakers in the west allow big tech monopolies to fleece small and medium-sized companies, China protects its mom and pop corner stores, restaurants and other small businesses from the predatory behavior of tech platforms.

While private education companies in the west are free to gorge themselves on the insecurities of parents, in China that behavior will no longer be accepted. While in the west, gains are privatized but losses are socialized, China aims to privatize the losses (as with Evergrande) and socialize more of the gains (as with the pressure on tech platforms to raise wages, hire more young graduates, and make big donations from their profits to charitable causes.

...and plays well at home amid fears of higher global inflation

China's leaders may be all the more keen to push this message to their domestic audience because of rising inflationary trends. China's current leaders were all raised in the Marxist church, where the first tenet of faith is that history is not shaped by individuals or ideas, but by economic forces—and inflation is the most powerful of these. To Karl Marx, Louis XVI would have kept his throne, and his head, had it not been for rapid food price inflation in the years before France's revolution in 1789. And to a Chinese technocrat brought up in the Marxist church, the Tiananmen uprising of 1989 only happened because inflation was running above 20%. So, as inflation around the world accelerates, it makes sense for China's Marxist leaders to start worrying about social stability, and to want to be seen to be doing more for the common man.

When it comes to international audiences, China's emphasis on common prosperity is another way for it to undercut what was once known as the Washington consensus in the eyes of the developing world. Until the 2008 mortgage crisis, the consensus view across the emerging markets was that the staffers working at the US Treasury, the Federal Reserve and the International Monetary Fund were the smartest guys in the room. However, the US banking system debacle disabused them of this notion. Suddenly, US policymakers looked as clueless about banking supervision as their counterparts in Indonesia, Turkey or Argentina had looked a decade before.

The western responses to the Lehman crisis and the euro debt crisis exposed the hypocrisy of the Washington consensus

Worse, the policy response embraced by the US in 2008—big increases in government spending funded by central bank money-printing—and by Europe in 2012-13 were the polar opposite of the austere remedies pressed upon Asia and Latin America following their crises of the late 1990s. In short, not only were the proponents of the Washington consensus no smarter than anyone else, they were blatant hypocrites to boot.

This brings us back to China's drive to promote the renminbi as a credible trade and reserve currency. China will never convince the US, France, Germany, Japan or the UK to settle their foreign trade in renminbi. But these countries are not the target of China's currency propaganda. Instead, what China aims to do is convince the likes of Indonesia, South Africa, Brazil, Russia and other emerging markets that China's economy is built on solid foundations. Highlighting a desire for common prosperity may deliberately emphasize what seems to be missing in the west today, and so obliquely points the finger at a source of potential western vulnerability.

So, one part of the world is emphasizing common prosperity, which implies that there is an inherent prosperity to be shared. Meanwhile, another part of the world talks of the need to "build back better," which implicitly recognizes that the current situation suffers from major deficiencies.

Isn't China heartened by the US exit from Afghanistan?

After Trump's attacks and the US takedown of Huawei I get why China might feel threatened and why Xi would have to hope for the best, but plan for the worst. But shouldn't the US exit from Afghanistan reassure China that taking down the Chinese Communist Party is not a US policy goal?

The news-flow around China is accelerating, and since this question was first asked, we have had the announcement of the AUKUS partnership.

AUKUS not FAUKUS suggests US defense deals are all about arms sales

It could be argued that the fact that the partnership is AUKUS rather than FAUKUS—the inclusion of France would have made for a better acronym —indicates that the deal is more about selling weapons than building a broad anti-China coalition. France, with its military bases in the Pacific and Indian Oceans, might have been a useful ally. Today, the US, UK and France are the only western powers with the ability rapidly to deploy forces far from their own borders. So getting all three together, plus Australia, would have sent a powerful message. But then, there was the sticky matter of the submarine contracts. So, between having an additional credible military ally in the coalition, or a contract worth tens of billions for the US defense industry, the choice was clear.

Not that this is much comfort to China, which has reacted to the AUKUS news with predictable anger, complaining about a new arms race and the partnership's antiquated cold war mentality.

Meanwhile, China has been quieter on Afghanistan. No doubt Beijing is relieved to see US troops retreat from the vicinity of China's land borders. The US occupation of Bagram air base, just 450km as the drone flies from the Chinese border, would have complicated any Chinese war plan tremendously. Now, China no longer needs to worry about a war on two fronts. Any hypothetical military confrontation with the US would now take place only along China's eastern seaboard. That's still unfortunate, given the east coast is where almost all of China's population lives, and where almost all of China's economic activity takes place (which is why China is so anxious to occupy outlying islands such as the Diaoyu, Spratlys and Paracels and create a first line of defense away from its economically-important coastline).

After the US retreat from Afghanistan, China no longer needs to worry about a western front...

So, yes, the US retreat from Afghanistan is broadly good news for China. But China may be less pleased with how the US left billions of dollars of military equipment behind to fall into Taliban hands. Seeing the treasure trove of abandoned US weaponry being paraded through Kabul streets, the Chinese leadership may well have wondered whether this got left behind through incompetence or deviousness.

...although Beijing remains concerned about unrest in Xinjiang

Could the US military have left these weapons behind in the expectation some might find their way through Afghanistan's porous borders into the hands of secessionists in Xinjiang? Was the calculus that just as America's chaotic departure from Vietnam helped to unleash hell in neighboring Cambodia, the US departure from Afghanistan would spread the armed *jihad* further east into China (see **China's Afghan Quandary**)?

In other words, it is not obvious that the US departure from Afghanistan will do much to sooth strained US-China relations. Worse, if US weapons start to be used against Chinese civilians in Xinjiang or elsewhere, Chinese resentment at the armed chaos America left behind will only grow. If so, it will only further amplifying the urgency with which China is seeking to develop its own tech hardware industry, embrace carbon neutrality, and dedollarize its economy.