BBA MONTHLY PROMONTORY

David Young, CFA
Chief Investment Officer

BRAUN-BOSTICH & ASSOCIATES WEALTH TRANSFORMED

February 2019

IS CHINA READY TO BLOW?

David Young, CFA
Chief Investment Officer

You don't have to be a sinologist to appreciate China's epic economic ascent. In an astonishingly short time - beginning in the early 1970s with the end of the disastrous Great Leap Forward to Deng Xiaoping's declaration that "to get rich is glorious" policy - Mandarins in Beijing created a model for growth that, within a generation, fostered world-beating corporations, amassed the largest foreign exchange reserves on the planet, and lifted hundreds of millions of people out of poverty.

Many of us remember the breathtaking pageantry of the 2008 Beijing Olympic Games, but for me China's most impressive achievement was framed in a news story about a vacant lot in the capital city that was used as an open-air movie theater for itinerant workers. There were scores of them - all men and of all ages. A generation earlier they would have exhausted their lives in the villages where they were born, having never seen a feature film let alone one in the imperial seat. Now they were part of the biggest cotillion in human history and on the emperor's generous terms: work, pay, dinner - and a show.

Back then - and for some years afterward - Beijing feared overheated growth, shortages of basic goods, black markets and parallel economies. Today, the most conspicuous scarcity is inflation itself as output has slowed to an estimated 6.2%, nearly half its rate of ten years ago. That's bad for both the Chinese who have come to regard a steady job as an entitlement, as well as financial markets, central bankers, exporters and anyone else with a stake in the global economy. If Napoleon famously cautioned the world to "Let China sleep," the world now pleads for her revival, stat!

Continued on page 2

If Napoleon famously cautioned the world to "Let China sleep," the world now pleads for her revival, stat!

China's benchmark stock index was the world's worst-performing in 2018 due to trade disputes between Washington and Beijing but also because of government efforts to deflate asset bubbles. Red-hot housing and infrastructure markets have been expanding since 2008 thanks to generous policy loans that are now strangling the economy with debt, much of which is not accounted for.

To be fair, this is the way China has delivered uninterrupted growth for the last quarter century. The problem, according to economists, is that new debt is being used to serve old debt and too much of it is being used for patronage rackets instead of means for growth.

Barron's reported recently that Chinese businesses are now 15% less productive than they were in 2007 due to "widespread and persistent interference in investment decisions—a problem that has been getting worse."

Since the end of 2012, *Barron's* warned, the share of new credit extended to China's state-owned enterprises has soared from about 50% to more than 80% as "China's vibrant pockets of private innovation have been squeezed for political reasons…. Zero productivity growth, or even continued declines, are likely."

The concussions from this seismic shift are already taking a toll beyond the Middle Kingdom. An influential manufacturing index for China sank in November 2018, below the 50 mark that represents contraction for the first time since May 2017. The sense of malaise spread elsewhere in Asia, with production activity in Malaysia and Taiwan shrinking to its slowest pace in years.

Meanwhile, Singapore's fourth-quarter performance was less than half the forecast 3.6% expected, due largely to China's grim outlook, while in South Korea, according to Reuters, "Order book volumes continued to deteriorate, prompting production cutbacks and stagnating employment."

Beyond Asia, Apple has already revised its revenue projections down in part because of tighter budgets in China, while U.S. steel mills cringed in response to China's first decline in auto sales in 30 years, at a time when U.S. sales are similarly evaporating.

Is this the end of the miracle economy? Probably not. Any country with 5,000 years of recorded history behind it is likely to survive a few slow quarters. China is no stranger to debt and it has a habit of making chumps of those who bet against its banks.

Continued on page3

China is no stranger to debt and it has a habit of making chumps of those who bet against its banks

That said, this party has to come to an end eventually and when it does there is every reason to believe it will be more of a problem for China than anyone else. Most of its debt is denominated in local currency, which limits the danger of contagion beyond China and perhaps even within the country itself; China has survived numerous regional bank-runs over the years because its relatively primitive systems have kept them from going national.

I would also argue that an economic slowdown - and even a minor recession - may well be good for China and, by extension, the global economy. Market-Leninism, as Beijing's reform rubric was once called, has reaped serious problems along with the gold-laying Mandarin Duck. Heaping subsidies on state-owned industries crowds out investment capital for more efficient enterprises, while Beijing's zero-sum-gain approach to foreign investors and trading partners has engendered a blunt and possibly ruinous response.

A significant setback would be a painful chastening with a cast of billions and far more innocents than bad actors. But it would force China's leaders to update their strategy to accommodate another 25 years of growth - hopefully as better global citizens as they are today.

Braun-Bostich & Associates, Inc.
1600 Ashwood Drive, Suite 1601
Canonsburg, PA 15317

Phone: 724.942.2639 — Fax: 724.746.1782