The View

CHINA GOVVIES: 2020S WIDOWMAKER

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This is the second in our series of Views exploring the divergence between the 2023 cyclical trajectory and dominant secular forces. Part one, Short China; Long US and UK can be found here

- **Balance-sheet recession in China over the 2020s makes CGBs the new widowmaker trade**
- **Green investment is a partial antidote to disinflation**
- **Economies that grew towards the light of China's unsustainable 2010s growth model will suffer in the 2020s**
- **But for H1/23 China macro and markets are likely to outperform**

Summary

This View is the second in our series explaining our framework for analysing cyclical and secular trends in growth and inflation in the 2020s. Below we look at the demand deflation quadrant. The main force in this quadrant in the 2020s is the legacy of excessive Chinese investment and debt in the 2010s. For China, demand deflation will be the secular drift for the 2020s, with those countries that were dependent on China's 2010s investment binge experiencing the same drag.

This quadrant favours bonds, with Chinese government bonds attractive on a longer-term basis, though not in the re-opening period. We worry that some of the capital gains in RMB terms, however, will be offset from the perspective of foreign investors, by depreciation of the currency in real terms.

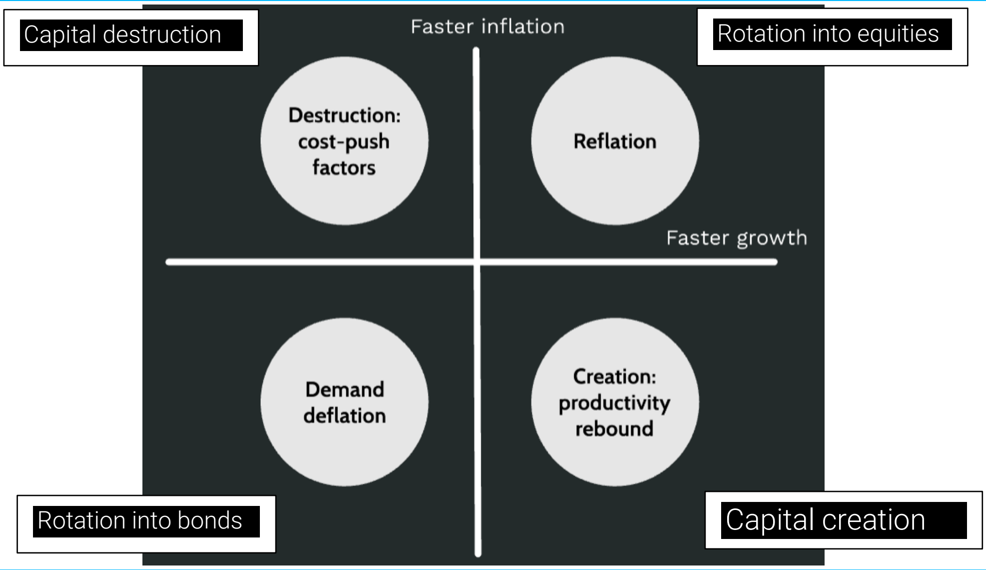
Growth: The Chinese economy itself, alongside all those regions reliant on Chinese growth in the 2010s will underperform previous growth trends, as these parts of their economies contract, causing demand deflation, while the income in these regions previously engaged in excess production is withdrawn. Within the DM space, the EA looks exposed, while the US and the UK are well shielded, dependent as they are on domestic demand.

Inflation: In the 2010s, China was a secular disinflationary force. We think this wage and price inhibitor is lifting, as we'll set out in forthcoming Views in this series. For some regions, however, China's deflationary impact will continue, though the mode is set to evolve. Deflation in the first two decades of the 2000s emanated from excess supply (and then deleveraging in DMs). In the 2020s, we think the Chinese authorities will shy away from large-scale defaults, leaving the options of demand compression (deflationary for China and its dependents), or depreciation (deflationary for the rest of the world).

In the 2020s, China's demand deflation will reverberate back along the goods and services supply chains constructed through the previous decade. All economies will be exposed to cyclical bouts of deflationary leakage, as the Chinese authorities seek to stimulate the economy, providing liquidity that will cause end-of-cycle RMB depreciation. DMs are likely to respond by speeding up the process of de-globalisation, shielding themselves from this aspect of China's deflationary spillovers. But China-dependants cannot shield themselves from the loss of income they will experience as China slows.

Nevertheless, the deflationary effects would have been more severe, were it not for the need to combat climate change. While we see clear similarities between China and Japan in the disinflationary effects of deleveraging, we note differences, in particular, the need to green the Chinese economy, which looks set partially to mitigate deflationary effects on the global economy.

In this View we explore secular forces pulling toward the demand deflation quadrant



Source: TS Lombard.

Quadrant 2: China secular slowdown

Quadrant 2 was the dominant secular force in the 2010s. The integration of China into the global trading system, which started in the early 2000s at an undervalued RMB exchange rate, took a significant and indirect toll on DM growth. The idea that China could catch up entirely from below as a result of that integration, without other economies slowing, has turned out to be untrue – it was a fallacy of convergence. Chinese investment accounted for a large share of global capex growth and was hugely excessive, with housing receiving an overweight share, dimming productivity growth.

From the DM side, most countries were deleveraging after the GFC. Globalization was still keeping a lid on wage growth. And policy was heavily weighted towards fiscal repair, plus monetary ease and cheap labour to remedy all ills. This concoction helped asset prices but did little for the real economy. At the same time, it forced down yields, which likely hindered productivity growth, too. In the next instalments of this series (to be devoted to the next two quadrants), we will look at the reversal of these forces as a driver of growth and inflation in the post-Covid cycle.

For many EMs and commodity- and export-dependent DMs, however, China's investment post-GFC, excessive and unsustainable though it was, was nevertheless a major growth driver. **This**

driving force is unlikely to be repeated; and just as the negative wealth effect and contraction of the Chinese property market is set to be a drag on China's domestic economy, so all those plants in the global economy that spent the 2010s growing towards the light of still-speedy Chinese growth will experience the same thing.

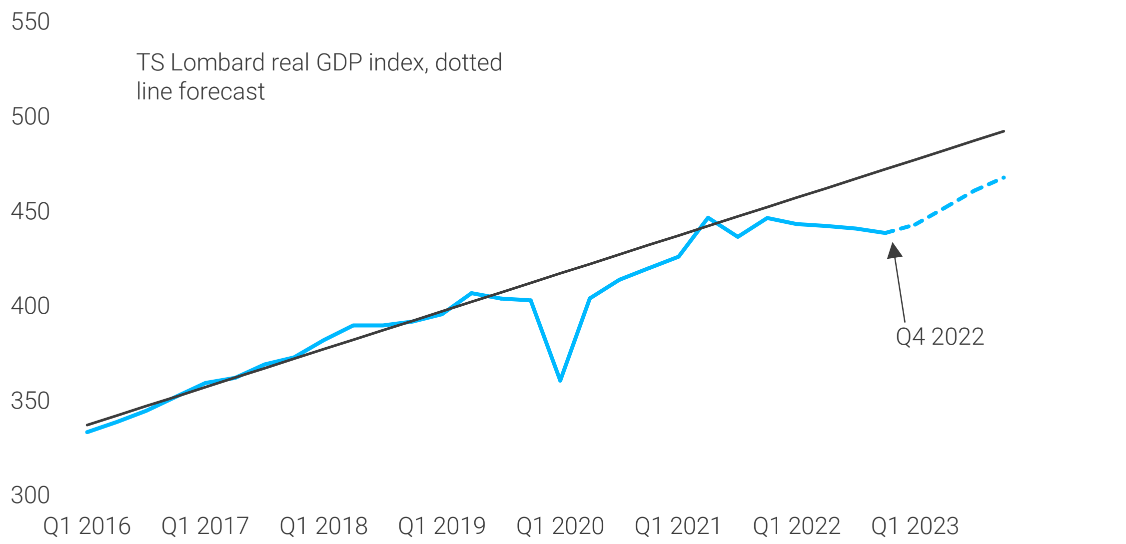
For the full story of China's slowdown in the next five years, we invite you to read China property dream turns to nightmare.

Market implications:

China: The demand slowdown we are forecasting, combined with the general political antipathy towards the creation by profit of any nexus of power outside of the Communist Party, paints a grim picture of longer-term prospects for Chinese equities, although we do still see momentum in the reopening story. When we say short China, however, the exception to that is in government bonds; but even here, the prospects for foreign investors are dimmed by the likelihood of secular depreciation of the currency in real effective terms. Again, as we write, this story is not the dominant driver of markets, with reopening continuing to auger higher yields.

Rest of the world: All DMs should benefit indirectly from China reaching the end of its speedy catch-up, as we set out in the next part of this series. But we favour those economies that are relatively demand-oriented and we remain wary of those that have become dependent on the unsustainable Chinese growth model. Within the major DMs, that means the EA continues to have a lot to prove.

China is resetting on a lower trend



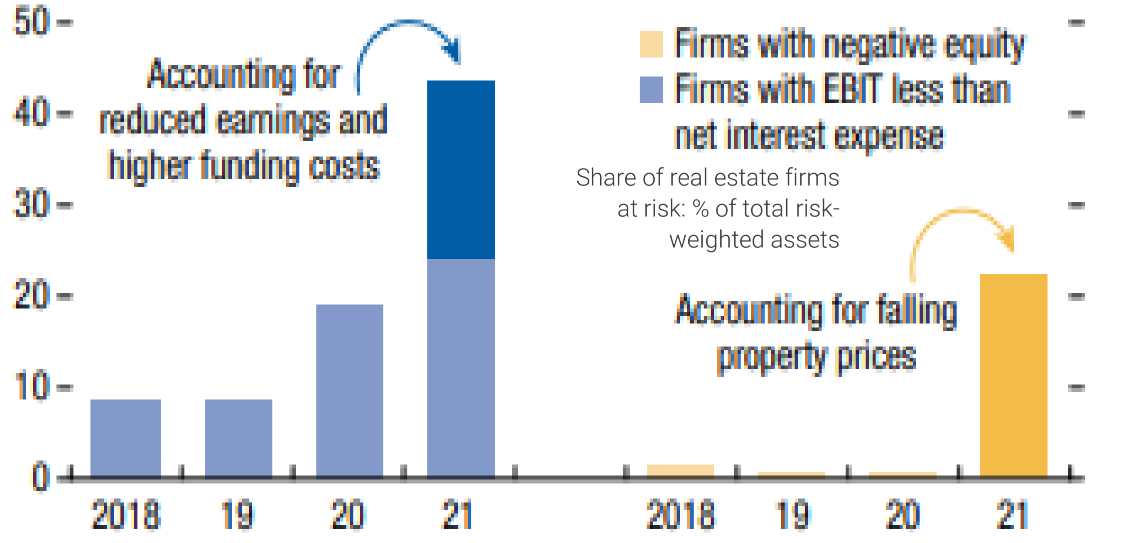
Sources: Datastream, TS Lombard.

The old model is broken – what next?

The debt party is over and the legacy of that burden will be carried, rather than shaken off, through large-scale defaults. This puts China at grave risk of sustained balance-sheet recession.

What of the transition to private consumption-led demand? Simply put, we cannot get behind the idea of active consumption-led growth until returns pick up. And that will not happen until the good capital is released from evergreening (borrowing to pay the interest on previous loans) at low-productivity firms. The IMF estimates that more than two-fifths of real estate firms had EBIT insufficient to pay for net interest expense in 2021 and more than one-fifth were already in negative equity, accounting for falling prices (which, admittedly, is quite hard to do).

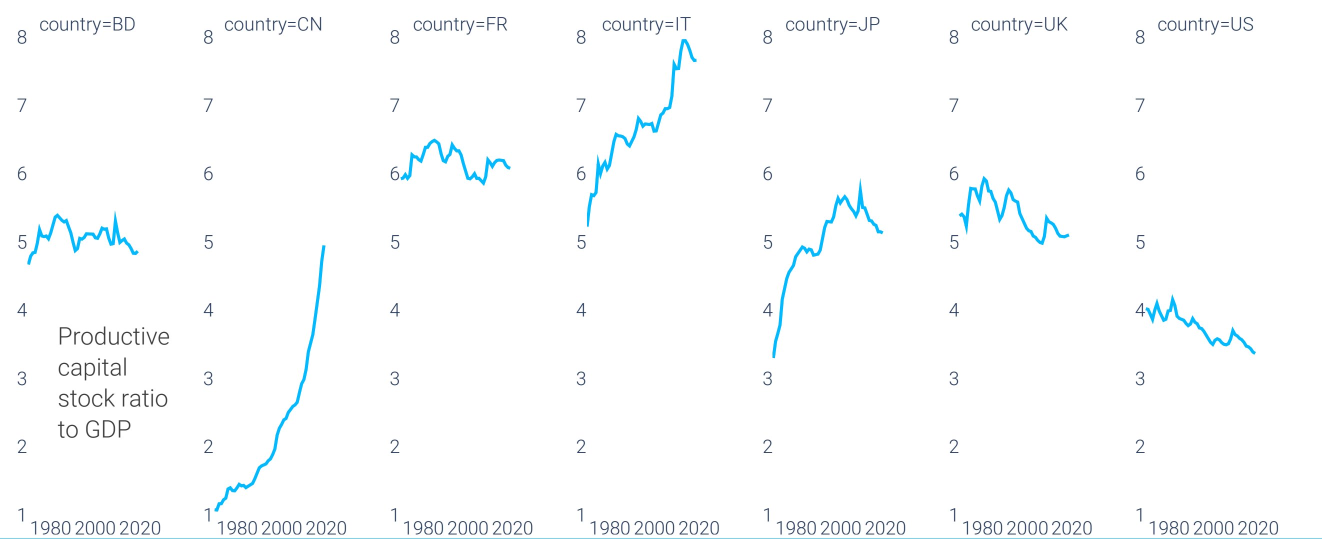
Evergreening is rife in China



Source: IMF.

To run a sustainable private consumption-led growth model, two things are necessary: first, wage growth; and second, returns on wealth. Where China falls short is in returns on wealth for the household sector. Otherwise, the economy – if it can afford to increase compensation at all – is forced to choose between paying labour or capital, undermining political stability. To have both wage growth and stable returns, productivity growth is needed. And productivity growth has been eroded by China's development model.

China's convergence is complete in terms of the capital stock to GDP ratio

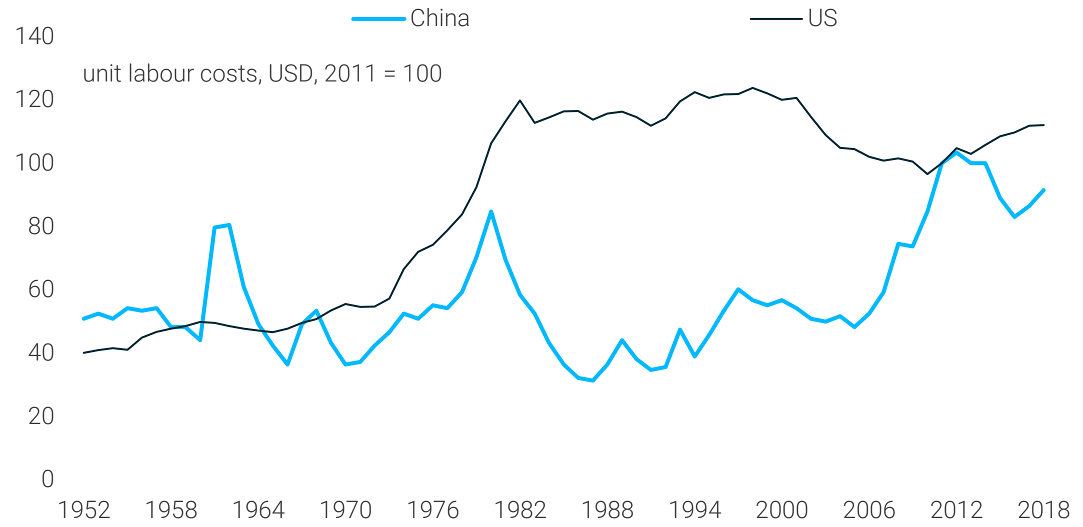


Source: Datastream, TS Lombard

The problem of the middle-income trap for firms that have followed an intensely investment-led model is that it is like digging a hole that is very difficult to get out of. If the currency is undervalued, they can get away with a lot for a long time. But during the period of undervaluation, the economy becomes addicted to unsustainable crutches, primarily credit and over-investment.

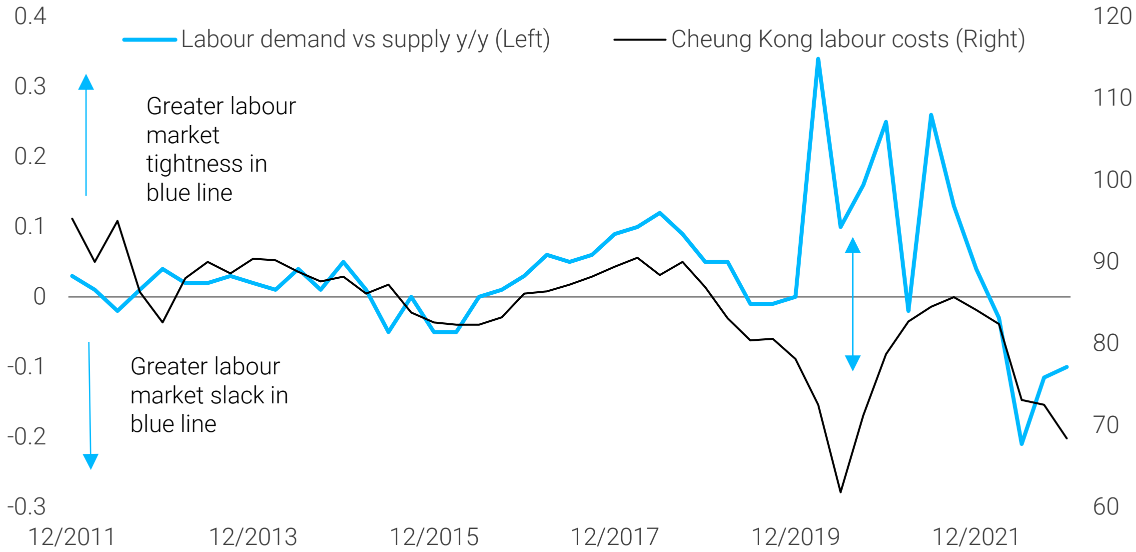
At the same time, depreciation rises as a share of GDP, meaning an increasingly large share of income must be diverted to maintaining an ever-more inefficient capital stock. Reversing these trends would mean accepting weaker growth in the meantime, and there is never a good time to do that.

China has hit the barriers on fast ULC growth



Source: Conference Board International Labour Comparison program, TS Lombard

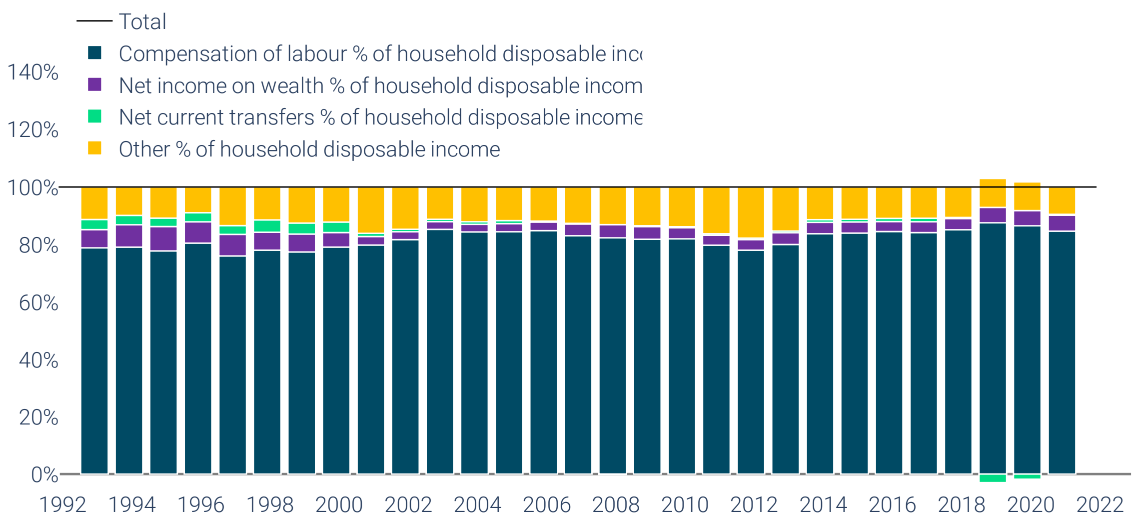
China's wage growth now seems less responsive to domestic tightness



Sources: Datastream, TS Lombard.

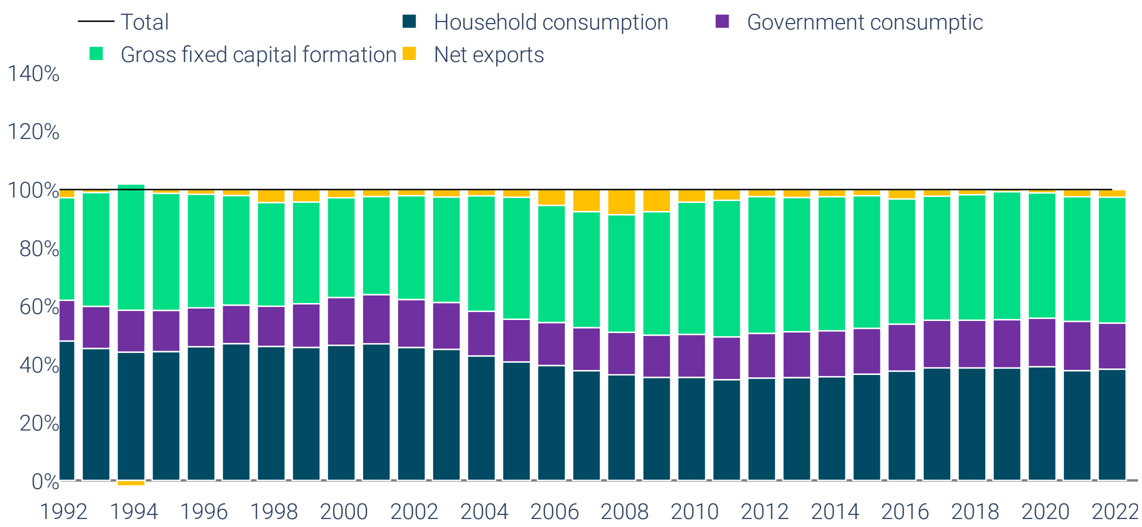
The easy gains for private-consumption growth appear to be in the past. The economy can no longer afford unit labour costs growing at a double-digit rate, as they did during the convergence period. Indeed, it is possible that China will now experience its own version of the flattening of economic relationships, in the same way that many DMs did during the 2010s. In short, it may now take more labour market tightness in China in order to generate the same wage cost growth, because Chinese ULCs are no longer extremely undervalued and appear to have come into balance (or probably overvaluation) with the rest of the world. Labour data in China leave a great deal to be desired, but the chart below shows a very weak reaction of wage cost growth to labour market tightening during the pandemic; in fact, the relationship already appeared to weaken before the Covid shock. Wage growth, therefore, is now going to have to pay more attention to productivity growth, which, given the large share of evergreening and wasteful use of resources, implies a significant slowdown in wage growth.

Deficiency of Chinese household income lies in low returns on wealth…



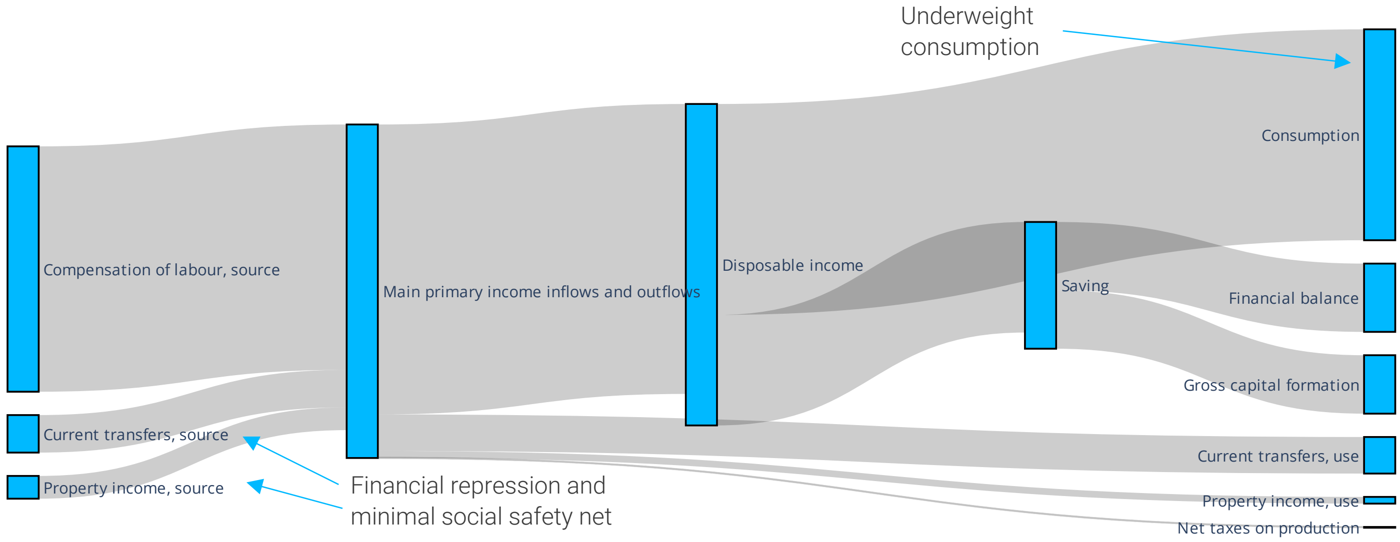
Source: CEIC, TS Lombard

...leading to deficiency of consumption expenditure



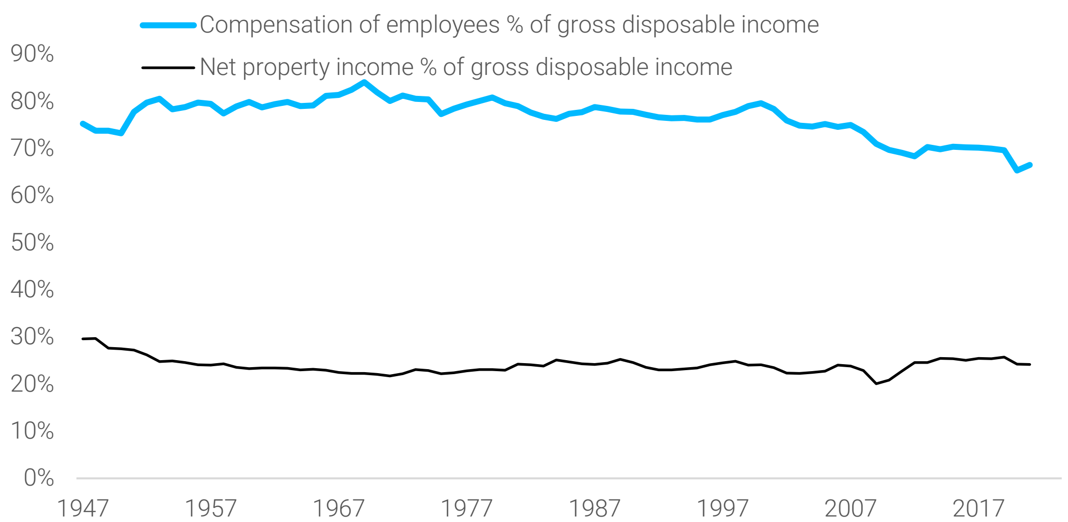
Source: CEIC, TS Lombard

Chinese households are inadequately compensated for their capital



Source: CEIC, TS Lombard

US income on wealth is a much higher proportion of disposable income



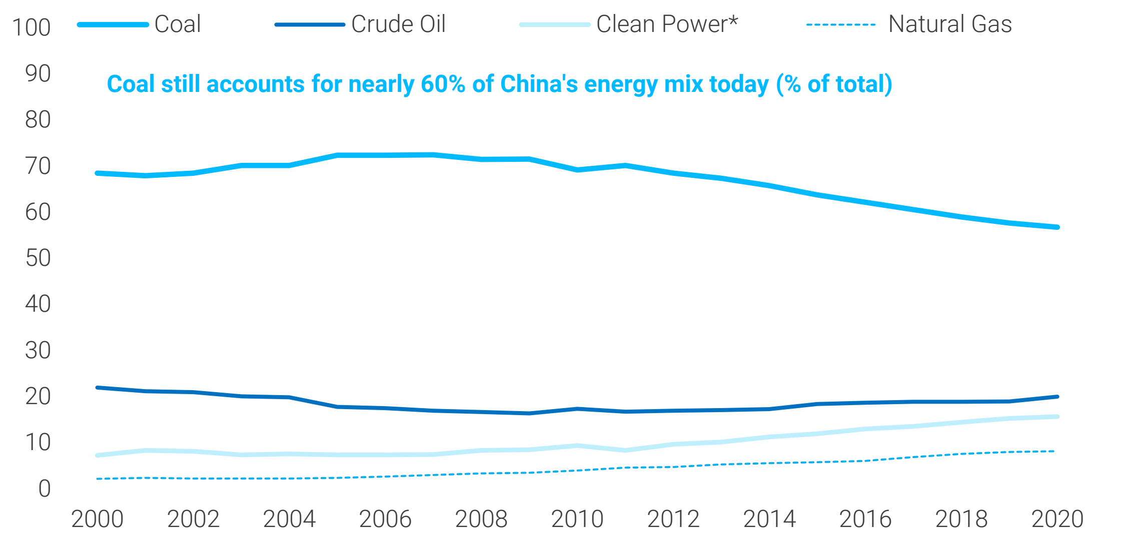
Source: Datastream, TS Lombard

Admittedly, *hukou* and welfare reforms are likely to bolster household sector confidence and reduce savings rates. Similarly, the aging of the population should help reorient household income away from savings and towards consumption. This was not the case in Japan, but that partly reflects the quasi-feudal nature of the country's labour market. However, the main driver of balance-sheet recession is the need to perpetuate high corporate savings, not for investment, as in the 2010s, but for balance-sheet repair.

Investment in greening the economy could extend the life of the capex-led model. And that tilts the story somewhat away from the deflation path, as government-led investment can soak up some of the corporate savings needed to deleverage. But the product of that greening is not more production; rather, it is the retrofitting of a very dirty and young capital stock, as well as cleaning up and protection. The youthfulness of the capital stock means that the authorities cannot just wait for the old investments to depreciate. It is a wonderful thing that investment to offset the deleveraging of the private sector is more likely to be used in improving the environmental outlook than in paving China's equivalent of Mount Fuji, but it does not necessarily mean much faster growth. Ultimately, this type of investment can help improve productivity at the margin, as older is being replaced with newer; but since there is only a more marginal increase in production than would otherwise have been the case, it is hard to see where the growth driver is – although it is fair to say that these productivity gains could be sizeable, and not just for China, especially if energy costs are brought down. We will investigate the potential productivity gains inherent in the energy transition in our discussion of the third quadrant.

While the size of the potential productivity gains is open to debate, it is true that, overall, RMB1 million of investment in a whole new factory increases production by much more than RMB1 million invested in retrofitting an old factory to make it more environmentally friendly. This means less output growth for China but adds to our conviction that the rest of the world will be released from some of the burden of Chinese excess production. As a result, the deflationary force will be less than if that investment had been ploughed into trying to support export share by expanding production. Instead, demand for resources for investment receives a boost, while supply enjoys only marginal gains.

China's capital stock is particularly dirty and young



Sources: CEIC, TS Lombard. *Includes nuclear

Implications for the rest of the world

As China slows, the main implications for the rest of the world are on the real-economy side (although the financial risks are not insignificant – for a summary, see Financial Pressure Points and When is an $80T debt a problem? from our Global Financial Trends service). The main point of exposure here appears to be through Japan.

As a house, we first pointed out the detrimental effects of excess savings from China (among other regions) in 2005, when my predecessor, Charles Dumas, identified a glut of Eurasian savings as a driver of unsustainable deficits in the US. The growth and inflation implications are multifaceted: China is probably a net contributor for some countries and a net drag, through indirect channels, for others.

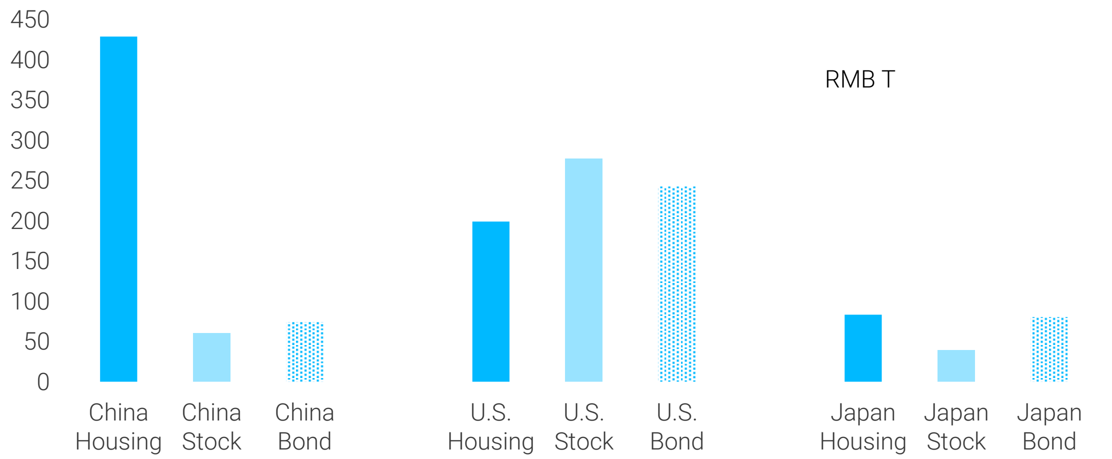
Growth implications

In the 2010s, China's growth model created both a driver and a drag for DMs.

1. **2010s driver**: China's contribution to global growth in the 2010s was to internalize the deficit that previously was run by the rest of the world, notably the US household sector. As willing foreign borrowers dwindled, the RMB appreciated and Chinese policymakers chose to prop up growth by borrowing through the corporate sector, with the private sector following suit, most notably in the real estate sector. By around 2016, the corporate sector was saturated and households took over, blowing the final air into the bubble that is the Chinese property market – the largest sector in the world. Those DMs that were integrated into the export machine or China's domestic investment, especially in real estate, received a boost. This driver added an impulse to growth for export-oriented economies, notably the EA, primarily through Germany, without any inflationary impulse. So, in the 2010s, China's role for many EMs and the EA was found in the third quadrant (positive growth impulse but negative inflation impulse). In the 2020s, the growth element of that is evaporating and China remains a disinflationary force, meaning China gravity for these regions in the 2020s will shift to the second quadrant.

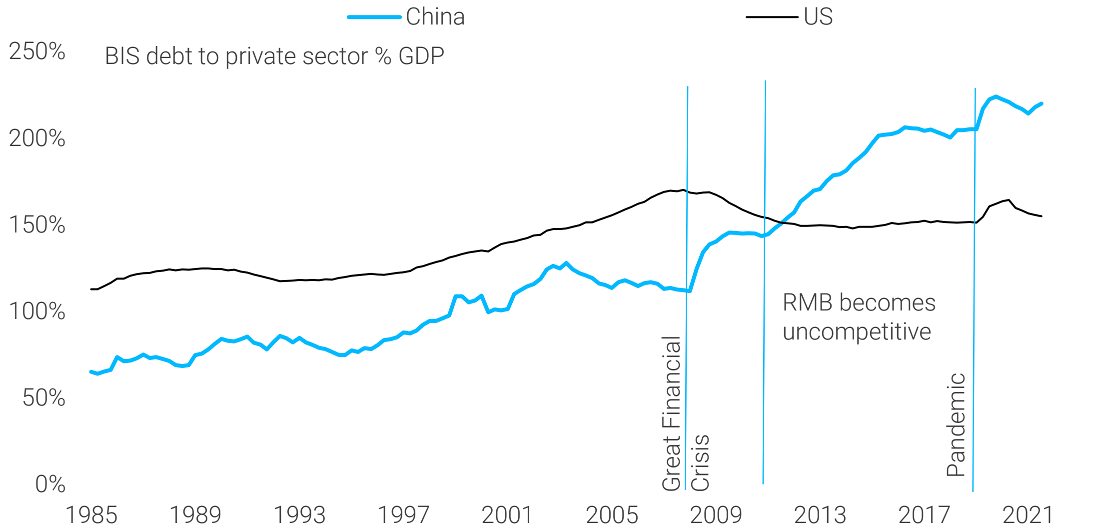
2. **2010s drag**: DMs suffered a warping away from productivity and income-driven growth in the 2010s as a result of China's development model. DM growth became reliant on cheap labour abroad, which was less costly than investment at home. Admittedly, excessive investment in China also contributed to the decline in core goods prices, making anaemic nominal income growth sustainable for more than a decade; at the same time, DM growth was maintained on a higher path pre-2008, thanks to the flipside of excess Chinese exports: surpluses to be allocated abroad. This financed debt, which supplemented hollowed-out middle incomes, until the subprime crisis hit. But by the 2010s, the DM private sector needed to deleverage and real growth (beyond failed attempts at stimulus) became predicated upon disinflation. In the 2010s, therefore, China's gravitational force in this sense on DMs was located in the second quadrant (weaker inflation and growth). Reversal of these drags on capex, wage and productivity growth is a major cause for optimism on DM trajectories in the 2020s – see our forthcoming discussions of the third and fourth quadrants.

The most important sector in the world



Source: 2018 China Urban Household Wealth Health Report.

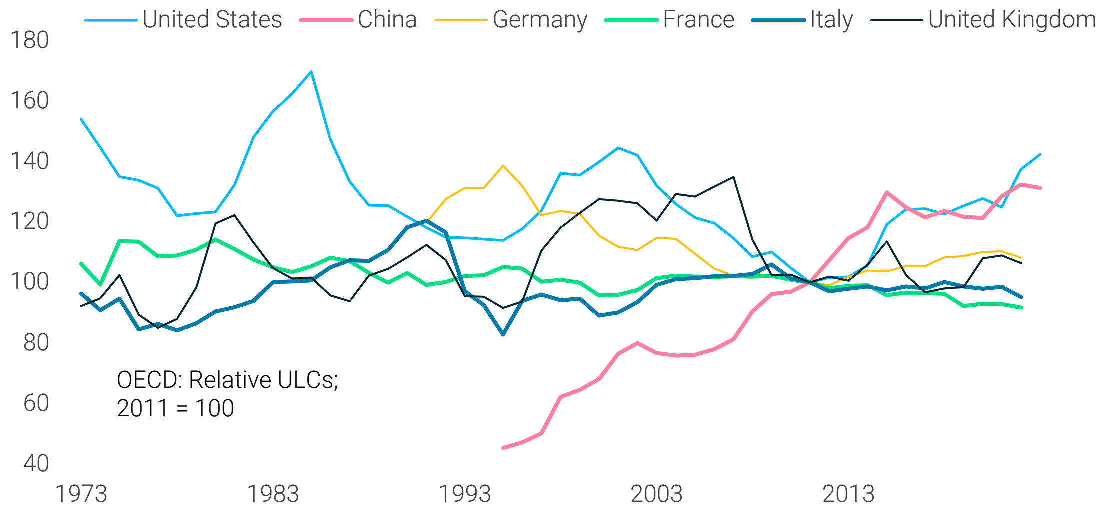
Chinese debt has hit a wall, but credit can return as a driver for many DMs



Source: Datastream, TS Lombard.

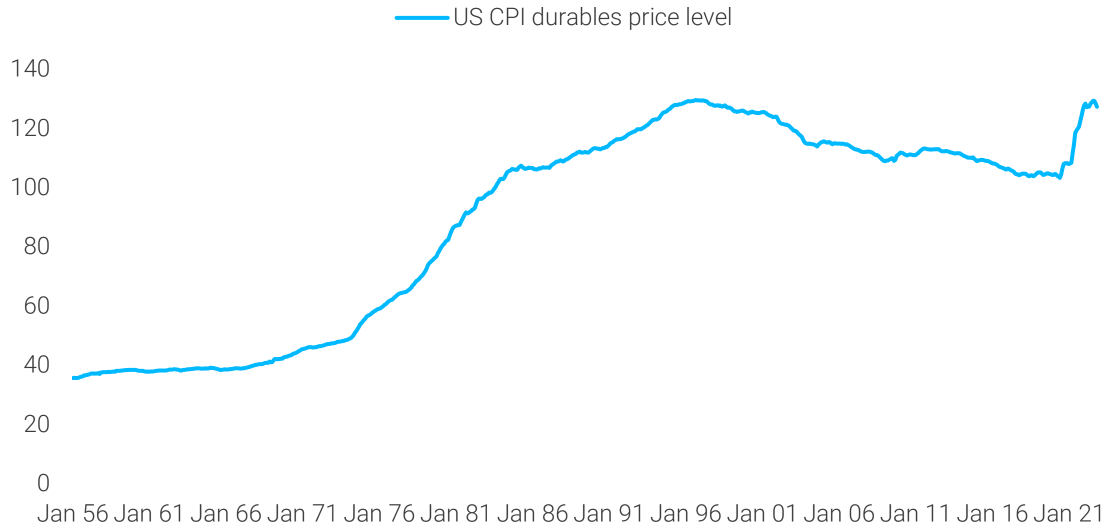
Inflation implications: As far as its role in global prices is concerned, China is shifting from a *secular* disinflationary force for DMs in the 2010s to *an end-of-China-cycle* disinflationary force, with DMs breaking free of the secular drag on prices. Since China entered the WTO in 2001, global consumers have benefitted from a drop in the price of core goods and, relatedly, lower interest rates. That disinflation and decline in yields is proof that excess supply and savings, rather than excess demand for goods or debt (read: houses), were the drivers.

China can no longer afford an inflationary debt-driven investment binge



Source: Datastream, TS Lomard.

China's undervalued incorporation into the WTO was a secular deflationary force



Sources: Datastream, TS Lombard.

China is not *solely* to blame for weak growth and low inflation (or to thank, depending on which side you were on). Staying with the savings glut prism of viewing the world, we can also identify an internal savings glut in many DMs, notably the US and the UK, driven by rising inequality among households. A rise in automation is in part to thank, although the hollowing out of the middle section of the distribution owes much to the offshoring of production. Owners of capital, meanwhile, found cheaper labour abroad, which both buoyed profits and contributed to sluggish labour income growth at home.

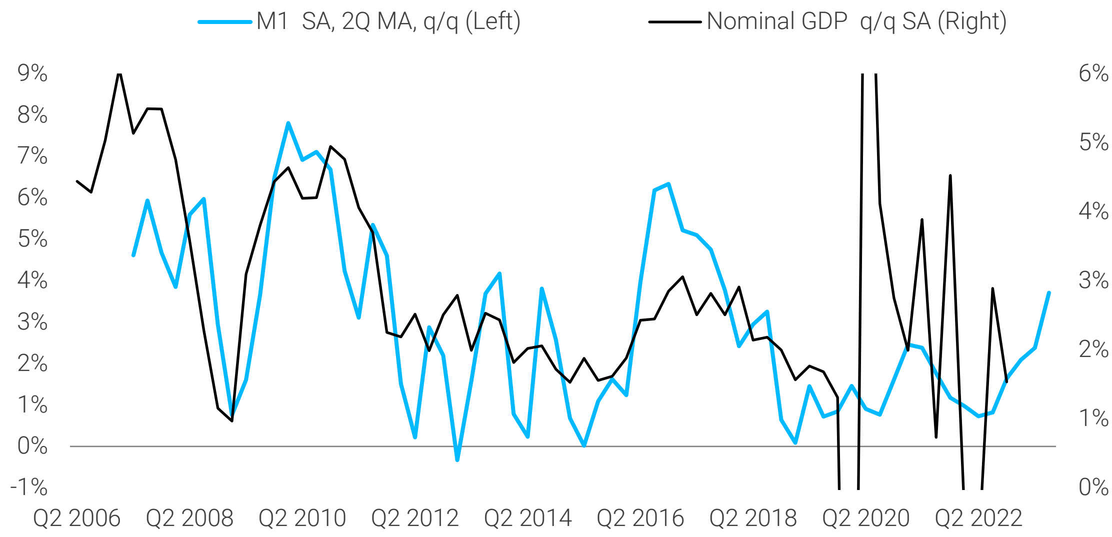
From secular to cyclical disinflation driver

China now faces a period of disinflation, which goes hand in hand with balance-sheet recession. As we laid out above, the prospects are perhaps not as grim as they were in Japan because it is less likely that investment to offset saving needed for deleveraging without default will result in excess supply in China. Nevertheless, demand will be on the back foot with the private sector leaning towards saving rather than consumption or the scale of investment seen in the post-GFC period.

This makes China look like a reservoir of deflation. One way for a leak from the reservoir to suddenly emerge would be if financial fragilities – analysis to which we linked to our GFT series above – were to turn live, pulling the RMB into sharper depreciation. Short of such a risk materializing, disinflation leaks out both through removal of the driver components above and through the Chinese authorities' likely attempts to stimulate the economy.

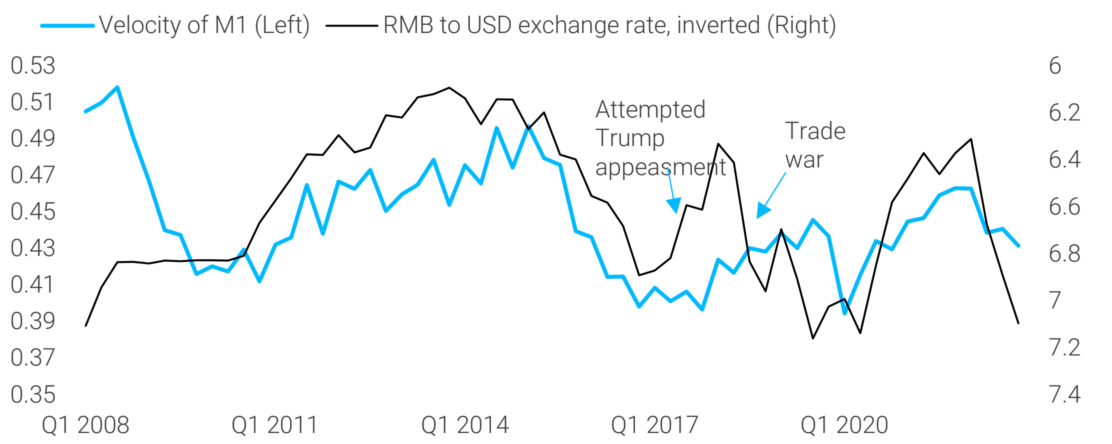
Understanding the recent history of the Chinese mini-cycle and the RMB's role in it is helpful here. In the second half of the 2010s, a China mini-cycle was established, where the authorities saw growth coming down to unacceptably low rates and then created liquidity to pump it back up again. This led to bouts of RMB depreciation, starting in 2015. The sharp rise in M1 growth through 2015 ran ahead of what the economy could initially absorb domestically, leading to capital outflows and depreciation of the currency. When the economy subsequently responded to stimulus, the currency began to appreciate again. And it did so more sharply during 2017 – probably owing to attempts to smooth relations with the US and the Trump administration – only to depreciate again when those efforts collapsed with the advent of trade war. It is hard to get a read on the relationship between the currency and monetary policy during this mini-cycle as geopolitics got in the way. The appreciation through the pandemic, however, was more in keeping with purely economic drivers, including the profile of liquidity growth compared with activity growth. Nominal GDP growth rose rapidly and ahead of M1 growth, meaning cash was in short supply and the currency appreciated, the reverse of what happened in 2015. As GDP growth slowed compared with M1 growth, the currency began to depreciate again.

Expect bouts of RMB-led disinflation, but bulk of adjustment will be demand deflation



Source: Datastream, CEIC, TS Lombard

China's deflation will leak out in spurts, but the secular drag on prices is diminished



Source: Datastream, TS Lombard.

Going forward into the remainder of the 2020s, as the mini-cycle turns down and the authorities become worried about whether they will hit their growth targets, the likelihood is that Beijing will again be enticed into creating liquidity, leading to bouts of nominal RMB depreciation.

Exposure to China 2020s trends

	China slowdown	*Re-shoring*
US	Minimal exposure	Main beneficiary, owing to domestic-demand orientation and lower energy shock exposure
UK		Decent beneficiary, owing to domestic-demand orientation but energy shock is a disincentive
EA	Significant exposure on real-economy side	Beneficiary but energy shock is a disincentive
Japan	Significant exposure on real and financial side	

Source: TS Lombard.

Current market direction versus the implications of China's slowdown

With reopening, the narrative is once again running in the opposite direction to the longer-term story. Chinese and EA equities have rallied, pushing valuations back towards long-run trends, with China-oriented commodities on a tear and bond yields having regained late 2021 levels. In our February edition of Global Financial Trends, however, we laid out how China's liquidity indicators currently suggest that this boomlet is unlikely to be typical compared with history in terms of its effect on growth or inflation in the rest of the world. Similarly, with the bulk of spending likely to be weighted towards domestic services and the property market remaining under pressure, China dependants are likely to find the spillover effects on growth disappointing. At the same time, the disinflation we are forecasting for 2023 reflects distortions coming out of the system, with the level of prices finding its new trend. This composition of spending in China, backed by only a modest upturn in liquidity growth, is unlikely to derail the disinflation in DMs, although we could see a bout of services inflation within China.

Markets seem to disagree with our prognosis of the effects on demand and supply generated by China's reopening – and we grant that growth in the first half is likely to be strong and that it will be difficult for markets to look through that until data in the second half begin to suggest a renewed slowdown. Similarly, with the PBoC reverting to old tools such as Pledged Supplementary Lending, some of this liquidity may leak into equities in the short run, with low interest rates making margin play look attractive to retail investors as well. All of this will mean that 2023 presents a better entry point for the themes we are discussing in this View series.