September 15, 2023

SKBA Economic Update

China Is Running Out of Rabbits!

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Pulling a rabbit out of a hat is an old staple among any magician's tricks. Companies sometimes play that game as well through ingenuity and good management but also with accounting or revenue recognition shenanigans. The goal is to meet or beat consensus earnings expectations that hopefully then drive its stock price higher. When there are no more rabbits to be pulled out of the hat, suddenly reported earnings fall short of expectations, and investors are disappointed.

From an economic perspective, pulling rabbits out of a hat isn't always bad. If there is a positive structural change in an economy, it can have lasting positive impacts.

Freedom, with its reward for the hard work and creativity of citizens, has tended to produce mostly good long-run economic outcomes, whereas with centrally-planned economies, particularly under totalitarian dictatorships such as was the case under Mao Zedong from 1949 to 1975, the impact on general wealth and welfare can be devastating. Over time, democracies have survived much longer than autocracies. While successive leaders in China have maintained their dictatorial control over the population, the shift away from the collectivization and strict central planning has greatly improved the economic lot of the average citizen. But it took a colony of rabbits to move the economy forward after Mao.

#1 Rabbit – Freeing Up Labor

Deng Xiaoping pulled giant rabbits out of the hat when he came to power in 1978 and opened up China's economy by eliminating collective farming, inviting foreign investment in the country, encouraging small business entrepreneurship with limited property rights, and requiring nine years of compulsory education. While the rule of law as we know it in the West wasn't well established, such reforms were equivalent to a fresh breath of freedom, removing a massive burden on the economy. Whether Chinese statistics can be relied upon or not (including Western estimates when there were no statistics available), real GDP is estimated to have accelerated to over 10% annually for nearly three decades (per data from Oxford Economics). Such a pace of growth tremendously benefited the world economy as well as China.

Harnessing the underutilized labor supply in China was part of this growth story. Yet, fear of overpopulation growth ultimately led to the "One Child" policy in 1978 at the same time as Deng's first reforms were put in place. Using estimates from Oxford Economics analysis, labor supply fueled 1.4% of this economic growth in the 1979-89 period, 0.5% over the 1990-2002 period, and only 0.3% through 2012. This rabbit ran its course, and China's population and labor supply are both now headed for steep declines in the coming decades. Labor supply cannot sustain China's past growth rates. No rabbit here – it went back into the hat.

#2 Rabbit - Currency Devaluation

Many countries have utilized beggar-thy-neighbor policies of radical currency devaluation to gain competitive advantage, but China became an expert at this (using data maintained by MacroTrends^). From January of 1981 when the Chinese Yuan traded at 1.63¥ per U.S. Dollar, the Yuan exchange rate plunged to 5.81¥/$ by December of 1993. Then in a sudden devaluation, it fell further to 8.73¥/$ by January 1994. Whether or not China denies these actions, the impact was to make products exported from China more competitive on the world markets while keeping local labor costs low. Foreign corporations were encouraged by such cost advantages to invest in Chinese operations. The growth in net exports, at the expense of domestic consumption, gave a huge lift to real economic growth for the country.

The risk that emerged was the labeling of China as a currency manipulator. Having created the exchange rate advantage (at least in the cost of exports sense), Chinese monetary authorities allowed the currency to rise and the exchange rate settled into a range around 8.28¥/$ that lasted for another decade until mid-2005. But the West was on to this game with threats related to currency manipulation, and the Yuan strengthened over nearly the next decade, rising to just above 6¥/$ in January of 2014. Although today's financial press cites the Yuan's subsequent weakness, pushing it down to 7.28¥/$ in August of 2023, this "rabbit" has done its job. The devaluation effort is costly now that 0% interest rates that made hedging inexpensive are gone. China's labor costs have risen dramatically over the decades, making it less competitive with other emerging-market countries and its growth can no longer be stimulated by devaluing its currency. China cannot repeat the currency devaluations of the past. No rabbit here.

#3 Rabbit – Chinese Bank Lending for Capital Projects and Housing

Easy money and low interest rates stimulated excess investment in capital projects and housing. We must confess that the Federal Reserve Board's Zero Interest Rate Policy helped China borrow heavily at low interest rates just as it did in the U.S. But focusing simply on China, easy money and massive borrowing were used to force feed growth in investment in the economy. We're now seeing the reverse impact as some Chinese corporations, like Evergrande and more recently Country Garden, may default on their debt obligations due to the massive over-building of residential and commercial properties.

Analysts constantly talk about the size and benefit of the next injection of Chinese stimulus, and it is true that it has the power to print money, borrow at the government level, and force continued investments that lead to overcapacity. Long periods of overinvestment in long-lived assets have a consequence – incremental stimulus has diminishing returns and effect on economic growth. We appear to be at the point at which China cannot simply command its economy to grow at the same rates as in the past. Just as deficit spending in the U.S. is also having negative consequences, China, with limited market-driven incentives, feels it even more. That rabbit just won't come out of the hat any longer.

#4 Rabbit – Pulling Off Getting into the World Trade Organization (WTO)

While trade liberalization can be a good incentive for a country to move away from a centrally-planned and command economy, hope often exceeds reality. After 15 years of negotiation, the West finally seemed to believe that China would reform itself once it was able to join the WTO. It became the 143rd member in January of 2001. It joined as a member while essentially making NO real promises to permanently reform its economy. China used its new status to attract massive investment by Western companies, to develop their dependencies on low-cost Chinese exports, and to "share" technology with mandatory local Chinese partners. The West was attracted by low costs and a big market while ignoring the risks.

But the jig is up on this game for China as the country's abuses of Western investment, its growing military belligerence, and its theft of intellectual property have started a massive reshoring effort by the U.S. and other countries. Although it will take years to see the full impact from the *reshoring* efforts, the shift of supply chains to India and Vietnam (as examples) as well as back into the U.S. will have a clear negative impact on China's net export balance. China faces the prospect of a shrinking rabbit in terms of trade benefits.

#5 Rabbit – Theft of Western Intellectual Property

Article I, Section 8 of the U.S. Constitution codifies the concept of importance of protection for patents, copyrights, and intellectual property rights. Paragraph 8 states, "To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to respective writings and discoveries." Thank goodness for this insight from our forefathers. Intellectual Property Rights Index.org ranks the U.S. as the #1 country for protecting intellectual property rights. It's a meaningful part of the U.S. success story. The other top country, Finland, is recognized as the #1 country for protecting physical property rights. The U.S. raw score that generates this ranking is 8.731 on Intellectual Property Rights. Finland's score is 7.25, and the worst score and rank was given to Yemen at 2.565. Nearly all European and Nordic countries, the U.K, Canada, Australia, and New Zealand, Japan, Greenland and South Africa (along with a few others) have scores above China. By our calculation, China's 6.275 score puts its protection rank at about 32nd, above a number of countries in South America, Africa and central Asia and certainly above countries that could not even be scored.

It's not that China isn't able to innovate, but it has resorted to intellectual property theft as an innovation strategy. This rabbit has been played out over at least the last couple of decades, and the West is finally paying attention. Beefing up security and restricting sensitive high tech chip and product sales will progressively kill the past benefit of having open-arm Western countries willing to enable China to keep up with Western gains in technology and innovation.

While China can certainly get some short-term benefits from stimulus or the cyclical rise in activity, it's not easy to turn the country into a consumer-driven economy. Can China make it without these rabbits? If growth slows to 3% when the market still believes it will return to 5-7%, will Chinese companies still be worth the investment? And what about those American companies that have come to depend on China as a key manufacturer and supplier in their own supply chains?

Let's step back and offer our definition of what makes a country's economic policies successful in the long term. While this list of attributes doesn't guarantee a country will avoid cyclical ups and downs in its economy or long-term success in financial market returns, it does provide consistent rules for citizens and companies to apply their creativity and skills to create growth. Among the attributes below, a list that generally applies to the U.S., we've taken the liberty of assigning a yes or no score as to whether China's system of government possesses these attributes.

	System Attribute	U.S. Score	China Score
1.	Separation of Government Powers	Yes	No
2.	Independent Supreme Judiciary	Yes	No
3.	Private Property Rights	Mostly	Limited
4.	Contracts Enforceable in Courts	Yes	No
5.	Stable Currency	Yes	Sometimes
6.	Mostly Free Trade	Usually	No
7.	Protection of Intellectual Property (Patents)	#1	Low
8.	Low Marginal Effective Tax Rates	Varied over time	Higher than U.S.
9.	Low Regulatory Burden	Not now	Far worse with command economy
10.	Freedom of Movement	Yes	No

As a country, China is weak on the mechanisms that make a country economically successful. If the rabbits disappear, China has no basis for sustaining extraordinary growth. And the problems are being compounded by Xi's return to tight control over and monitoring of what its citizens say, do, and think that was set up during the COVID pandemic lockdowns. The rabbit colony worked for decades, **but it seems to have disappeared.**

China now appears to be headed for a similar experience as typical corporations that has run out of rabbits to pull out of the supreme leader's hat. U.S. corporations with large exposure to China are likely to suffer as well. So while Chinese stocks may appear to be selling at cheap valuations, in our investment parlance, they are cheap for very good reasons.

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^Data Source: www.macrotrends.net. Disclosure: The information contained herein represents the opinion of SKBA Capital Management, LLC and should not be construed as personalized or individualized investment advice. Analysis and opinion expressed in this report are subject to change without notice. They do not represent a buy or sell recommendation and should not be viewed as a promise of future performance. The securities identified and described do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable.