First Trust
ECONOMIC RESEARCH REPORT
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Senior Economist*
Andrew Opdyke, CFA – *Senior Economist*
Bryce Gill - *Economist*
September 22, 2021 • 630.517.7756 • www.ftportfolios.com

China Worries Unwarranted

Prior to today, the S&P 500 index was down four days in a row, and many market observers are blaming China, specifically the recent news about Evergrande, a major Chinese real estate company that looks to be heading to default on its loans. While many will credit last night's Chinese liquidity additions as saving the day, we were never that worried about Evergrande. We want to address this, but before we do, let's take a step back for a second and talk about why China is where it is today.

Chinese GDP has grown around 9% a year for the last 25 years. Impressive to say the least and something no other country in the world that we know of has been able to achieve. But how do you grow a country by 9% a year for 25 years? Measures of output like GDP really come down to two major factors: growth in the labor force (hours worked) and growth in productivity (output per hour). On both fronts the Chinese have been blessed in recent decades.

The best prescription for unprecedented productivity gains is simple.

1. Do nothing for thousands of years.
2. Then borrow everyone else's technology.

It's not due to communism, in fact it's the exact opposite! China's rapid growth was only possible because Deng Xiaoping decided in 1982 to move China to more of an open, market-based economy. Because of that decision, hundreds of millions of Chinese have been brought out of poverty. Was it a truly free market? Not even close. But it was a massive change and it allowed China to adopt the world's technology, resulting in massive productivity gains.

Think of China over the last thirty years as a Ford Model T with a rocket engine strapped to its back. It's been great as it has continued to move forward in a straight line, with the rocket of capitalism speeding the country forward. But because of this, the Communist Party's power has been weakened over the decades. It now looks like President Xi Jinping is responding forcefully, trying to reverse the trend and move back to a more centrally controlled economy to regain lost power to the detriment of the people. And when you try to make a leftward turn in a Ford Model T with a rocket engine strapped to its back it's not pretty. The Model T eventually hits a wall and blows up into thousands of pieces. This is what China is in the early stages of as President Xi tries to move power back to the state.

The examples of President Xi bullying private companies into serving the Communist Party's agenda are everywhere. Earlier this year they halted the Ant Financial IPO, which would have been the world's largest. He's gone after China's tech sector, where lots of the money and power lie, launching many probes, slapping on heavy fines, and blocking mergers. The top six Chinese tech stocks have lost $1.1 trillion in value in the past six months. And it doesn't stop there, the $120 billion private tutoring sector was wiped out with a single administrative order. No one knows where the regulation will stop. Political risk there is infinite. Influential billionaires routinely disappear.

We've always thought the idea of China supplanting the US on the world stage was reminiscent of elite US opinion about Japan in the 1980s. Back then Japan was the big new thing much like China is today. It was going to beat the US. You couldn't go to a good business school and not read book after book about what the Japanese were doing. And that brings us to demographics and China's labor force.

Japan's stock market famously peaked in 1989. Less well known is that is roughly when their working age population peaked as well. Japan has still not come back, and their working age population is still on the decline.

According to the United Nations, China's working age population is currently hitting its peak as well and is set to decline by over 40% by 2100. The Communist Party is directly to blame; it's the inevitable effect of their centrally planned one-child policy. What China needs is to move further towards free-market capitalism, not reverse course. Communism has never worked and never will.

But instead of recognizing this, the Communist Party has doubled down and moved on to Chinese real estate as President Xi tries to crack down on visible wealth inequality with what is called a policy of "common prosperity." Over the past decades Chinese real estate has boomed as the Communist Party has mostly barred access to global financial markets to its people. Real estate was an asset most normal people were able to buy that felt safe and reliable. In fact, owning property in China denotes a higher status in society.

As the Chinese saved hand over fist, money continued to pump into real estate leading to ever-rising prices, causing many areas to be over-built and leading to LOTS of mal-investment. In fact, about 70% of household wealth is tied up in real estate. Much of this over-building and funneling of money into real estate was a direct result of poor centrally planned policies, with the most notorious example being the "ghost cities" without a soul living in them.

Now with more avenues for investment and a shrinking population in the future both hurting demand for real estate, this bubble seems to have burst. Other private real estate companies, besides Evergrande, may default or go under. But will that bring contagion to the US? We don't believe so.

Banks in the US have very little exposure to Chinese real-estate. There may be some hedge funds that do, but no large banks. A default has been considered a dirty word ever since the mortgage crisis in 2008, but that was due to mark-to-market accounting which turned a fire into an inferno. Companies were forced to mark assets to illiquid market prices, which, in turn, made them look insolvent on paper, even if the underlying mortgages were still paying on time. We do not have mark-to-market accounting in place in the US today.

Nor will an economic slowdown in China harm the US in any significant way. S&P 500 revenues coming from the greater China area, which includes Hong Kong and Taiwan, accounted for only about 2% of revenues in 2019. Remember, US growth accelerated in the 1990s when Japan started stagnating and back then Japan bought a larger share of our GDP than China does today.

The idea that China is the driving force behind the recent market drop ignores all kinds of other issues. Serious immigration problems, the potential for politicians to pass $4.5 trillion in new spending and big tax hikes, a desire to move toward socialism in the US, inflation, a potentially tightening Fed, the Delta variant, the debt ceiling, or the fact it's been so long since the last correction could also be spooking the market. The bottom line is that China is not anywhere near the largest of our worries.