A Personal Note On The Hong Kong And China Equity Meltdown

Louis-Vincent Gave
lgave@gavekal.com

This might sound horribly sheltered—perhaps even naive—but I actually grew up with no idea that my dad had made a fair bit of money for himself. No doubt we lived a very comfortable, *bourgeois* lifestyle. My siblings took private music classes (when I asked my mum why I did not, she said that not only did I have no musical ear whatsoever, but on top of that I could not stand still, so she felt it was unfair to impose this on an unfortunate music teacher). But we spent our holidays with my grandparents' who lived out in the countryside in Gascony, my parents drove normal cars, we went to local Catholic schools, etc. I grew up playing rugby, not golf (the fact that I still like to lace the boots might actually be a sign that I have yet to grow up).

The late-1990s Asian crisis offered me my first real taste of an economic collapse

The reason for the above self-centered statement is that I started my financial career with Paribas (before it was taken over by BNP) as an equity analyst. When Paribas decided to expand into Asia (needless to say, just before the late-1990s Asian Crisis!), I was shipped over from Paris to Hong Kong. The Asian Crisis was a terrific training ground for the young analyst I was then. I remember calling my dad and telling him "I did not know currencies could fall -10% a day for days on end (as the Indonesian rupiah was doing), to which Charles replied, "well, that is funny, though not amusing."

1) Learning through the Asian Crisis

Throughout this financial reckoning in Asia, I would speak regularly to my dad on the phone. He had just retired and had time on his hands. But as my mum pointed out at the time, having a retired husband is the worst of both worlds: more husband and less money.

Charles used the aftermath of the Asian crisis to load up on high-quality companies using me as his analyst

Anyway, by July 1998, or roughly a year after the Thai baht devaluation had sent most of the region's currency, bond, equity and real estate markets into a tailspin, my dad told me that things had likely fallen enough and that he wanted to invest some of his buyout money (he had sold his firm to what was then Alliance Capital) into Asian equities. He tasked me to identify 10 companies that had healthy balance sheets, minimal US dollar debt, and were not going to go bust.

I went to work and came up with a list of 10 "blue chip" names. After passing this list on to my dad, he informed me that he would put roughly three times my annual salary in each of these 10 companies. I was taken aback by the amounts. As mentioned above, I had, until that point, failed to think much about my parents' financial situation. The amount, at the time, struck me as being disproportionately large.

Anyway, positions were taken and sure enough, markets kept spiraling down: Russia defaulted and Long-Term Capital Management imploded. In August 1998, the Hong Kong government stepped in and hoovered up some 15% of the Hang Seng index's free float, spending US$15bn, or so, in the process. The aim was to squeeze speculators who were simultaneously shorting the Hong

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Kong dollar—triggering a rise in the local interbank interest rates—and the Hong Kong stock markets—which were falling partly because of the above rise in interbank rates.

Hong Kong's interbank lending rates shot up during the 1997 crisis

Gavekal Research/Macrobond

By the summer of 1998, it looked like the Hong Kong dollar could follow other Asian currencies down the plughole

The short squeeze was on. At the time, most of the financial media went apocalyptic: barely a year into Chinese rule, Hong Kong was ditching the free market/non-interventionist stance behind its success. Surely this intervention would trigger disaster? The Hong Kong Monetary Authority was wasting the resources needed for the peg's defense. The Hong Kong dollar would soon follow the Thai baht and Indonesian rupiah down the currency drain.

Living through all of this, I remember dragging myself into work and being physically ill looking at my screens. The Asian names I had recommended to my dad just a few weeks before had promptly lost between a third and half of their values. On paper, the amount of cash that had been incinerated was my annual salary many times over. There were days when I could not look at the screen. But on the other side of the phone, my dad was nonchalant about all of this. He would simply ask: "Are the companies going bust?", to which I would reply: "No. I do not believe they are", and then he would casually say "Then we are fine. We are just in the middle of a panic and eventually these cheap stocks won't stay that cheap".

It did not work out that way and by Christmas 1998, Charles's portfolio was back in the green

Needless to say, Charles was right. By Christmas, the portfolio was in the green. Of course, I advocated to my dad that, we should thank our lucky stars and liquidate the whole thing in order to walk away whole. Yet Charles demurred and within a year, our portfolio was sitting on very decent returns.

Following all of this, my father sent me a framed version of Kipling's *If* poem which our reader surely knows, but which I nonetheless reproduce overleaf, if only because I like it so much:

If you can keep your head when all about you
Are losing theirs and blaming it on you,
If you can trust yourself when all men doubt you,
But make allowance for their doubting too;
If you can wait and not be tired by waiting,
Or being lied about, don't deal in lies,
Or being hated, don't give way to hating,
And yet don't look too good, nor talk too wise:

If you can dream—and not make dreams your master;
If you can think—and not make thoughts your aim;
If you can meet with Triumph and Disaster
And treat those two impostors just the same;
If you can bear to hear the truth you've spoken
Twisted by knaves to make a trap for fools,
Or watch the things you gave your life to, broken,
And stoop and build 'em up with worn-out tools:

If you can make one heap of all your winnings
And risk it on one turn of pitch-and-toss,
And lose, and start again at your beginnings
And never breathe a word about your loss;
If you can force your heart and nerve and sinew
To serve your turn long after they are gone,
And so hold on when there is nothing in you
Except the Will which says to them: 'Hold on!'

If you can talk with crowds and keep your virtue,
Or walk with Kings—nor lose the common touch,
If neither foes nor loving friends can hurt you,
If all men count with you, but none too much;
If you can fill the unforgiving minute
With sixty seconds' worth of distance run,
Yours is the Earth and everything that's in it,
And—which is more—you'll be a Man, my son!

2) Having a knotted stomach

What really upsets me is losing money for reasons that I do not understand

Since then, I have had many more chances to feel like throwing up while looking at screens: the 2008 bust and the Covid meltdown definitely stand out. But there were many others instances along the way. Still, what I have come to realize over such periods is that a knotted stomach does not come so much from losing money, **as from losing money for reasons that I do not understand.** It is the struggle in the conceptualization of the reasons behind a loss that makes me reach for the sick bucket.

For example, in 2008 I walked into the Lehman Brothers crisis with a meaningful—at least for me—position in Indonesian government bonds. And as Lehman went bust, Indonesian bond yields spiked, triggering massive paper losses that made little sense.

Indonesian bonds spiked during the Lehman crisis

Gavekal Research/Macrobond

March 2020 was a good example of this, as I falsely assumed that Western policymakers would take a rational response to managing Covid-19

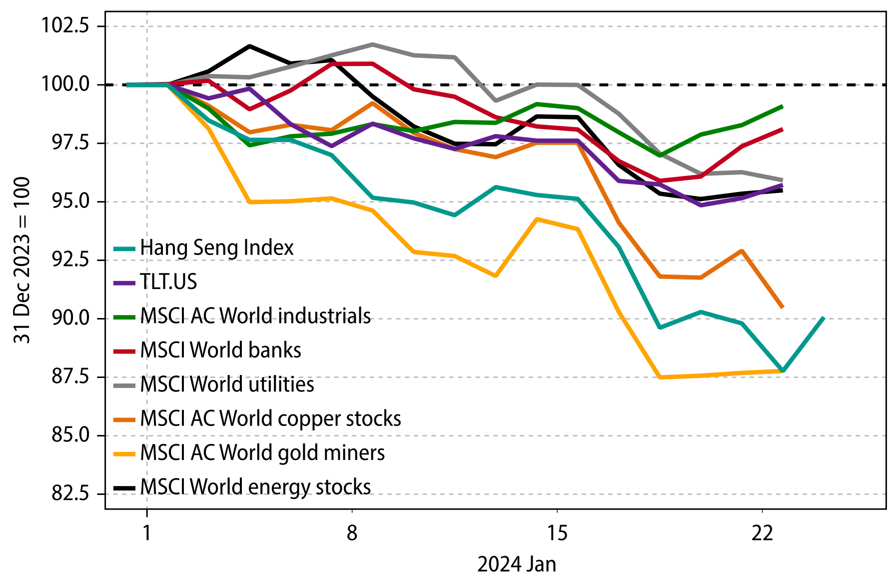
The same was true in 2020. Having lived through the Sars crisis of 2003, I sneered at the Covid hysteria. After all, surely this was just yet another bad flu coming out of China? As my writings at the time bear witness, I underestimated the ability of Western policymakers to tilt "full idiot." I had assumed that, between following a Sweden that had decided to remain open (and ended up delivering the best outcome for its population), and following Italy, which was the first country to impose a lockdown, the choice would be easy. After all, the health systems of most countries were not as run-down as Italy's and thus did not risk being overwhelmed.

Clearly, I underestimated the extent to which "cover your behind," rather than history, precedents, individual rights, personal liberty, or simple common sense had become the driver of public-policy responses (see **The Guiding Principle Of Our Time**). Looking at the red spreading across my screens, I once again had that gnawing feeling in the pit of my stomach: "Not only am I losing money but the reasons make no sense."

3) As January goes, so goes the year?

I have had the same gnawing feeling in the pit of my stomach in the first few weeks of 2024 as in past busts

Anyway, this is an long introduction to say that as 2024 rolls around, that gnawing feeling is back in the pit of my stomach. Its is due to the meltdown in Chinese and Hong Kong stocks that seems to defy past pullbacks in these markets (my favorite data point is that the H-share index is now trading at 4x cash flow, or below the Nasdaq's 6x price-to-book ratio). But it is also because January has seen dramatic pullbacks in gold and copper mining stocks, energy plays and industrials. Amid rising geopolitical tensions, blocked maritime passageways and threats of World War III, gold and energy names have been beaten up like red-headed stepchildren. Moreover, Chinese equities are melting down even though, as the world's largest oil importer, China should be the biggest beneficiary of falling oil prices.



There are two main explanations for the early-year collapse in Chinese equities

Such market behavior should lead us to one of two possible conclusions. The first is that China is now economically imploding (cue a fall in the price of energy, copper, gold, industrial stocks and, of course, Chinese equity markets). The second is that some serious liquidation/unwinding trades have been put on over the past few weeks.

4) An implosion in China?

Now, to be sure, China's economy is struggling. All real estate-related data remains dismal and one-time bright spots like automobile production are falling prey to the Chinese curse of excess bank lending to too many players who then use the capital for price wars to try and gain market share (see **The EV Implosion**). But is the economy really collapsing? Car sales (partly thanks to the above price war) are making new highs, internal tourism is booming, cinema box office receipts in December hit record highs, as has the trade surplus. By any measure, China is not Thailand in 1997.

5) Eating bitterness

The leadership in China has continued to ask the population to "eat bitterness"

Against this backdrop, one might expect China's top leader, Xi Jinping, to emulate Franklin Roosevelt by telling his countrymen some version of: "The only thing we have to fear is fear itself." But, counterintuitively, Xi is grabbing every chance to do the opposite, with his recent speeches highlighting how these are challenging times, how young people should revise down their expectations and take whatever job comes their way, how "eating bitterness" builds character and how tightening belts today will help China to come out stronger. He has not encouraged individuals to leverage up, consume more than they can afford, buy a bigger house, start a new business, *carpe diem,* etc. So why is Xi sounding so austere in his communication?

The first, and undeniably simplest, explanation is that Xi is a somber and serious guy, for let us not forget that his generation, in its formative years, was chucked out of universities to till fields with bare hands. Having endured the Cultural Revolution, Xi's generation most likely has a very different pain-level tolerance and definition of what constitutes hardship. Meanwhile, the power structure of China's leadership means that no one in the ruling elite is likely to tell him: "Hey boss, maybe lighten it up a little in the next speech? We need the masses to feel optimistic about the future, not downbeat!". Instead, the people around Xi, along with the Chinese media, will take the main points developed by Xi and reemphasize them in their own communication.

As Arthur Kroeber has argued, China's leaders think the country should be on a stringent diet so the country stays strong

The second possible explanation of the somber speeches is what my colleague Arthur Kroeber dubbed the "broccoli versus cheesecake" paradox of Chinese policy a decade ago (see **From Cheesecake To Broccoli: China's New Diet**). While cheesecake may taste better than broccoli, most readers will know that in preparing to run a marathon, it makes more sense to have a broccoli-based diet than a cheesecake one. To this extent China's policymakers now believe that the country is locked in a long-term, marathon-like, struggle against a US that holds almost all the cards: energy independence, food independence, reserve currency, technological dominance and control of the oceans. Hence, if the US is intent on taking China down, for China's leadership a broccoli diet makes sense. Given where China is, and given its challenges, there is no point in going for sugar rushes that will only weaken the body over time.

The third and surely most controversial possibility is that Xi is following Deng Xiaoping's advice for those following him to "hide your strength and bide your time." After all, having assumed the presidency, Xi seemed to wantonly disregard this advice. He announced the Belt and Road Initiative, the Silk Road Fund and funding for the Asia Infrastructure Investment Bank. He also talked about the China Dream and his desire to make China the world's major superpower by 2049. Xi spoke of China producing its own passenger jet planes within a decade, becoming an automobile exporting powerhouse, a global leader on green technologies, dedollarizing trade across emerging markets and turning renminbi bonds into a reserve asset.

These were all highly ambitious goals that unsurprisingly triggered a sharp US backlash. First was President Donald Trump's trade war. Second, the trade war morphed into a tech war and a semiconductor embargo that actually risked bringing the Chinese economy to its knees. Third, at the time of the

Hong Kong student demonstrations in 2019, US diplomats very publicly sat down with some of their leaders and allowed themselves to be photographed in the Marriott hotel (imagine the outrage if on January 6, 2020, Chinese diplomats had been photographed with the shaman or podium guy!). Fourth came the disastrous March 2021 meeting in Alaska between Antony Blinken and senior Chinese foreign policy officials, which confirmed to Beijing that being "anti-China" was no longer a "Trump issue", but had become the one single policy that both the left and right in the US seemed to agree upon.

6) Following Deng Xiaoping's advice

It may be that Xi Jinping is reverting to the dictum of Deng Xiaoping to conceal China's true strength

Following all these experiences, perhaps Xi concluded that Deng had been right to advise a circumspect playing of one's cards. That downplaying, rather than trumpeting, of China's achievements—whether taking over the global solar panel business, its newfound ability to build nuclear power plants far more cheaply than competitors, strong growth in electric vehicle production, or its surging trade with other emerging markets—was sound policy. Or, in other words: "If we keep saying how bad things are, maybe the Americans will be more reluctant to beat up on us as they will worry about derailing global growth. They want us weak, but not too weak."

To illustrate this last idea, consider China's trade position. After all, countries with trade surpluses of US$70-80bn a month do not typically go bust (actually, we don't know since China is the first country to ever run a trade surplus of US$70-80bn a month!).

It is hard to imagine a country running massive trade surpluses facing a genuine economic crisis

China's trade surplus is surging

Gavekal Research/Macrobond

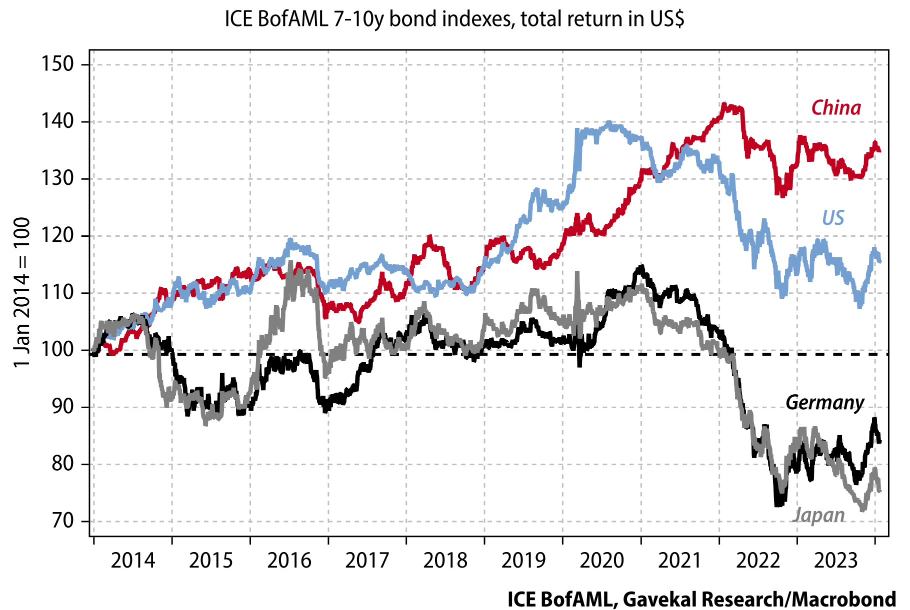
Still, whatever explanation among the above three turns out to be right, the message coming through loud and clear from Xi's speeches, but also the actions of the Chinese Communist Party, is that **stock market returns are pretty low down on the leadership's list of policy priorities.**

7) Bonds, not stocks

Chinese policymakers have favored the performance of bonds and the currency

Of course, this is not new information. Charles and I have spent the past 10 years highlighting that given China's attempts to dedollarize its trade, the People's Bank of China should be thought of as the "new Bundesbank," or the one central bank that cares more about returns on its government bonds and its currency than whatever the equity markets might end up doing. And to be sure, over the past decade, returns on CGBs have indeed crushed the returns on US treasuries, Japanese government bonds or German bunds.

Chinese government bonds have outperformed over the past decade



Some investors see communist dogma behind Chinese policymakers' lack of interest in equity performance

Many investors see the looming specter of communism behind the Chinese government's lack of interest in equity market performance. And yes, I see the irony of capitalists concluding that the lack of intervention by China's government in equity markets is an egregious sign of rampant communism. The logic runs that as share prices collapse, state-owned enterprises—which have easy access to bank credit—can swoop down and buy assets from distressed private-sector companies and so consolidate more of the economy under the government's thumb (hence the rampant communism accusation). Of course, this logic assumes that China spent the past 40 years liberalizing its economy—and thus experiencing tremendous growth—to ultimately turn around and recapture the assets it spent two generations privatizing.

Alternatively, perhaps the view of China's political leaders today is not that different from Charles's view in 1998 amid the Asian financial crisis. They are effectively asking: "Is this a good business?" In cases where the answer is "no," perhaps the view is that the business should be allowed to fail rather than be saved through a panicked intervention.

Behind this nonchalance *vis à vis* the equity meltdown lies a couple of very important differences between the US (and most other Western economies) and China when it comes to equity markets.

1) The number of people in China who own stocks is estimated at roughly 200mn, or 15% of the population. Contrast this with the US, where some 70% of Americans not only own stocks, but actually depend on them for their retirement benefits. This means that stocks falling in the US can rapidly become a political problem. In China, far less so (not that China's policymakers have to contest elections anyway).

2) In most countries, the main purpose of equity markets is to help firms raise growth capital (at least that was the idea before the emergence of what we called "platform companies" in our 2005 book ***Our Brave New World***). In China, few companies actually fund their growth through equity issuance. Growth is typically either funded through cash flows—especially for the smaller, privately-owned companies—or through banks in the case of larger corporations and SOEs.

For Chinese policymakers, the stock market carries far less "economic weight"

In China, the stock market does not carry the same "economic weight". In the US, a collapsing equity market is a disaster due to wealth effects on consumption, plunging tax receipts and falling capital spending. In China, it is not that equity market returns are low on Chinese policymakers' list of priorities—it is just not clear they even make the list to begin with!

8) Turning Japanese

Reflecting on this with a friend over drinks this week, I highlighted that if stock market returns were the be-all and end-all, then San Francisco or Seattle would surely rank as the best places in the world to live. After all, not only does the region enjoy pleasant weather (well, maybe less so for Seattle!) but it is home to the world's best-performing companies. At the same time, equity charts would point to Hong Kong being a dystopian hell-hole.

Yet it was San Francisco that was forced to tackle, at least temporarily, its rampant homeless problem and open drug use when world leaders visited last November for the APEC meeting. Meanwhile, in Hong Kong, the fact that air pollution has become less of a problem and Mainland Chinese tourist arrivals have reduced has made it a more enjoyable city to live in—getting taxis is easier, restaurants are half the cost of Singapore's and easy to book, getting tickets for the Rugby Sevens tournament is no longer a challenge and office rents are cheap. Over drinks, my American friend and I concluded that, while making money in Hong Kong had become darn near impossible, it had drifted back to being one of the best major cities in the world to live!

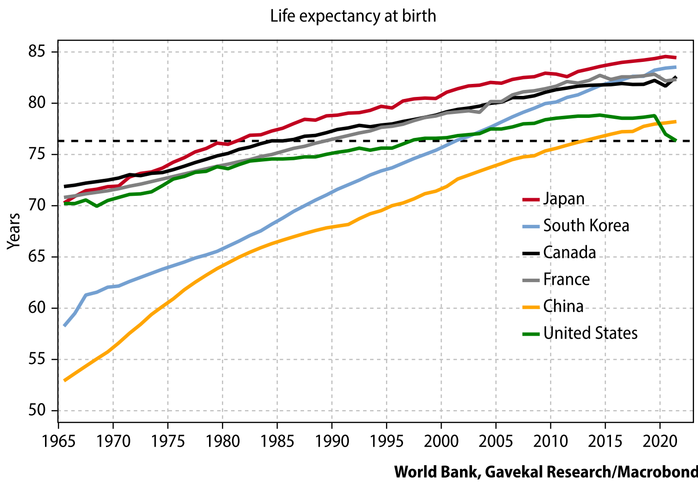
One effect of the repricing seen in Hong Kong over recent years is that it has become a more pleasant city

Upon making this statement, I turned to my friend and said: "You do realize that we've basically become Japanese?". Indeed, through the 2000s, whenever meeting friends from Japan, the discussion always seemed to be a variation of: "Sure, our stock market only goes down and it is impossible to make money here. But Tokyo remains one of the best places in the world to live in. We have the best food. Our streets are clean and safe. The trains run on time. Everyone is polite and courteous." Fast forward a decade and suddenly it is those of us living in Hong Kong that are making the same arguments!

Despite today's statement by Premier Li Qiang calling for the market to get "forceful" state support, expectations of a Chinese government "plan" to help boost domestic equity prices have been repeatedly dashed. Falling equity

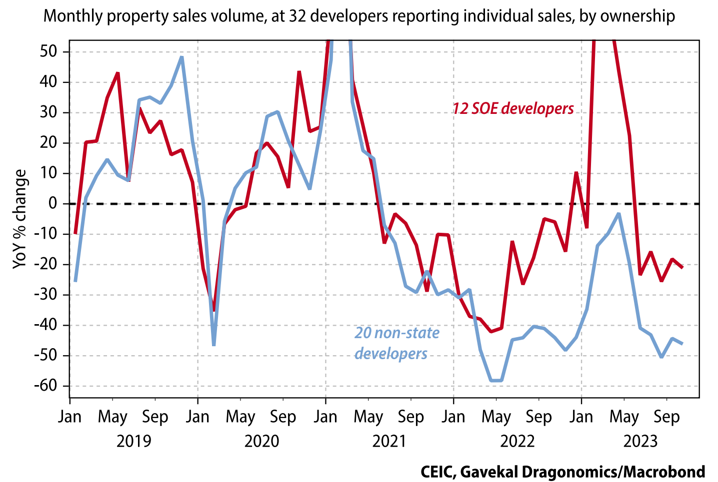
prices are simply not as much of a "social issue" as they would be in the West. And on most objective "social" criteria, the lot of most Chinese has greatly improved in the past decades: life expectancy has risen, deaths in childbirth and of young children have collapsed, malnutrition has been vanquished, incarceration rates have fallen to a quarter of those that prevail in the US.

US life expectancy has stagnated for a generation



World Bank, Gavekal Research/Macrobond

Sales are down a lot for both state and non-state developers



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9) Broken trust

Still, as the government sits on its hands, the trust between equity investors—whether foreign or domestic—and the Chinese government is now broken. The dialogue between investors and the government resembles that between myself and my teenage boys, with me asking them: "What is wrong with you? Is it ignorance or apathy?", only to be answered "I don't know and I don't care" (see **Where Now For China's Investibility?**).

The reality is that the model of property development used in China is broken

This is frustrating as China's government could boost confidence by undertaking some fairly easy and inexpensive reforms. The obvious drag on both growth and investor sentiment is the ongoing downturn in real estate and new construction (last week's stock market meltdown in Hong Kong seemed to be triggered by worse-than-expected real estate data). And behind this continued downturn lies the reality of China's broken real estate developer model. Simply put, the days when homebuyers would blithely deposit 15-30% of an apartment's value upfront with a developer are long gone since too many have gone bust. Even state-owned developers, which at the start of 2023 seemed to benefit from concerns over the solvency of their private-sector counterparts, are now struggling to get people to put money down.

A historical parallel might be banks in the US in the 1930s when investors feared that banks would fail and i incinerate people's savings in the process. The rational thing to do was to take one's money out of the bank, even if that action intensified the US banking crisis. Eventually, the US government stepped in with the Federal Deposit Insurance Corporation and, up to a certain sum, guaranteed bank deposits. This gave savers confidence to keep their money in the bank and allowed the US economy to pick itself up.

Today, should the Chinese government really want to put a stop to the rot in real estate and stock markets, the creation of an FDIC-like insurance scheme for property deposits (an insurance policy that property developers would have to pay for and could be modeled on their own level of risk) would no doubt give a terrific boost to investor sentiment.

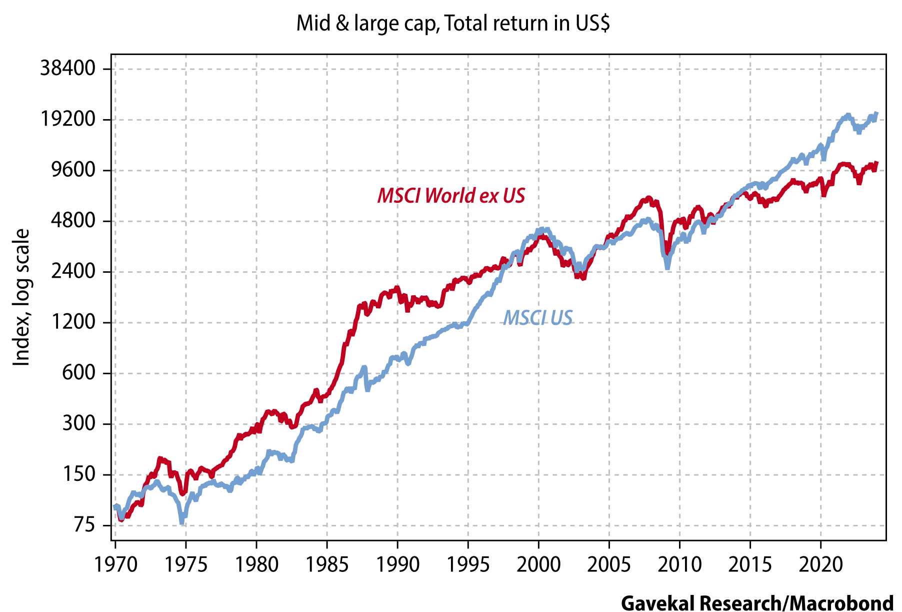
Failing that, the obvious potential catalysts for a rebound in Chinese equities will likely have to come from the bottom-up rather than the top-down; i.e., better corporate earnings, share buybacks and shrinking share counts, or even the unleashing of new and exciting business models.

10) Necessity is the mother of invention

Pretty much all of the US stock market's outperformance since 1969 has occurred in the last decade

On this last point, it is interesting to note that since MSCI launched its indexes in 1969, the MSCI US index has outperformed the MSCI World index by a shocking 96%. This begs the question: what is the point of international diversification? But here is the fun bit: up until 2012, the US was actually underperforming global equities. Put another way, all of the US equity market's outperformance has occurred in the past decade.

US equities have outperformed global stocks in the last decade



This shift in the US marks a big difference to common assumptions held about the US economy 10 years ago

This is fascinating, because if one goes back to the consensus investor mentality that prevailed in 2009-12, the general view was that a US economy that had to digest the aftermath of its 2004-08 real estate bubble was in a "new normal" of low GDP growth and poor stock market returns. At the time, the talk was full of "balance sheet recessions" and "Japanification".

So what happened?

With the benefit of hindsight, it turned out that the most important event of 2007 was not the start of the US mortgage bust—as terrible as it felt at the time—but the launch of the first iPhone. Another stupendously important development, highlighted in my 2012 book ***Too Different For Comfort***, was the US shale oil revolution. But to cut a long story short, necessity became the mother of new inventions.

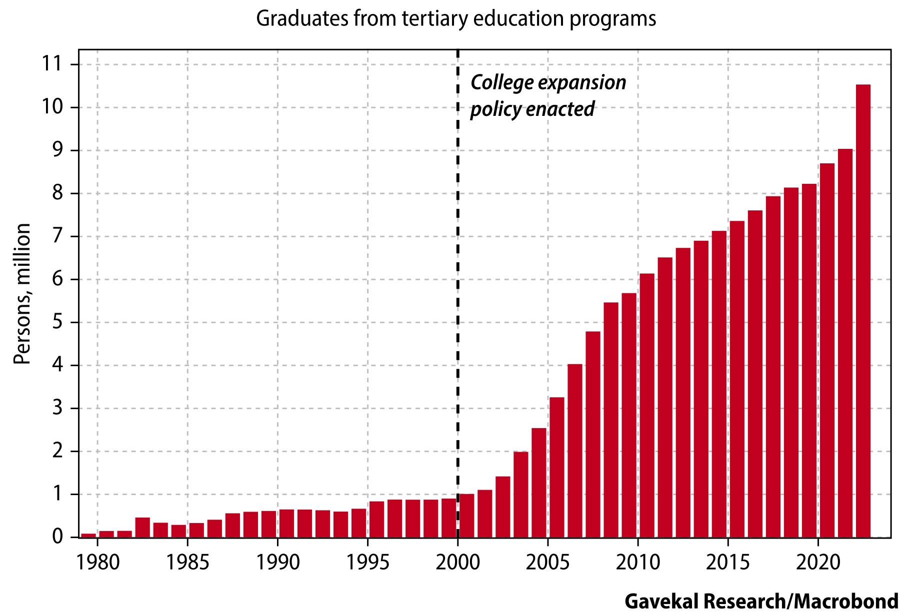
So could we see the same thing in China?

China now has a record number of graduates coming out of its universities

Thanks to the generosity of my parents, I got to study in China in the mid-1990s. Back then, China was turning out roughly 500,000 university graduates a year. In June 2023, Chinese universities printed up an estimated 11.58mn degree certificates, an increase of around 1mn over 2022. Since the early 1990s, the number of Chinese graduating from university each year has risen more than 20 times. Since the turn of the century, the number is up 10 times. No other society has ever gone through such a rapid transformation.

College graduates have grown 10-fold since 2000

Graduates from tertiary education programs



Gavekal Research/Macrobond

Almost all of the 11.58mn Chinese students receiving university degrees this summer were the first university graduates in their families. Anyone who subscribes to the belief of French humanist Jean Bodin that "*il n'est de richesses que d'homme*"—the only wealth is man—can only rejoice at this development. A more educated workforce should make for a more productive workforce, a better society and so on. This is all the more true since, out of the 11.58mn university degrees awarded last year, I would venture that none were for "grievance studies," or other socially divisive topics.

However, even more than failing property developers and over-leveraged local authorities, this surge in university graduates may be the most important immediate challenge for China's economy and the government leadership.

As my colleague Didier Darcet outlined in **The Fate Of The World**, one of the biggest disconnects in the global economy is how:

It is not clear that China's industrial structure can absorb so many university graduates

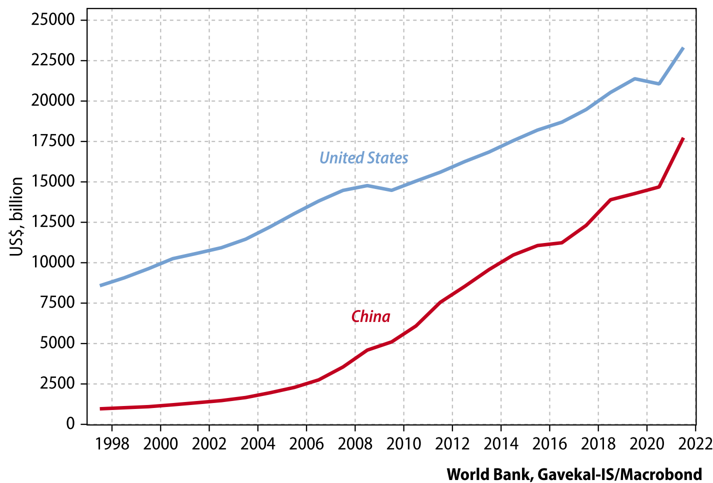
- In the US, the tertiary/service industry is massive, while the secondary/manufacturing industry is now smaller than China's.
- At the same time, in China the service industry is small relative to the size of the overall Chinese economy.

As Didier put it:

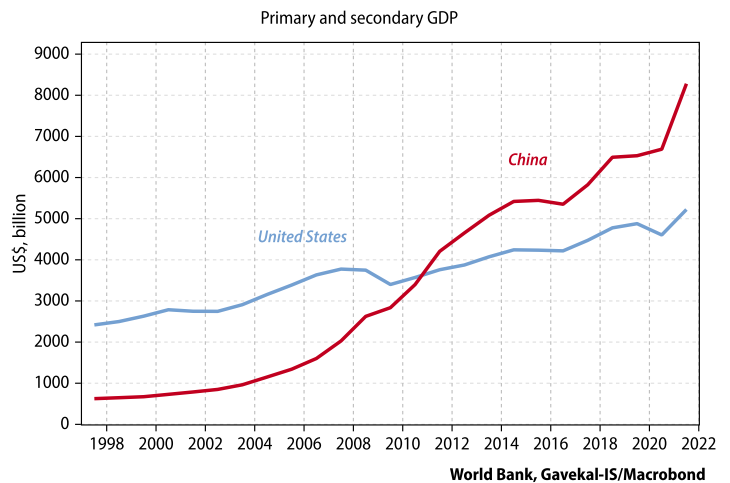
"For all the talk of China eating the US's lunch, by 2021 China's economy was still only three quarters the size of the American one. In economic terms, the US still enjoys clear leadership over China.

However, if the calculation of output is restricted to energy and manufacturing, the picture changes. On this basis, China began to produce more tangible goods than the US in late 2010, and the divergence has now reached 60%."

The US economy is still far bigger than China's economy



In terms of energy and manufacturing output, China has shot past the US



This goes to the heart of the challenge for the Chinese leadership, which can be summarized as follows:

China's tertiary industry is small relative to its economy—certainly compared to most Western economies—yet China continues to churn out more and more university graduates. Most of these graduates hope to find jobs in the service sector as young university graduates typically want to work at a desk with a phone and a personal computer. Few went to university hoping to lay bricks, pour concrete or fit widgets to gizmos on an assembly line.

Because the service industry in China is still young, it is not as if there are 11.58mn service sector workers retiring at the end of the year to make room for the 11.58mn university graduates. The result has been high rates of youth unemployment that have captured media attention. It led to Xi Jinping, as mentioned earlier, telling China's young people to "*chi ku*," or "eat bitterness." In other words, they should take whatever jobs they can find, even if those jobs are below the level implied by their qualifications.

Over the last 20 years the CCP has done everything it could to create new jobs

This was quite a departure from the Communist Party's mantra of the past 20 years, or so. In the first two decades of this century, the Party always gave the impression that it was responsible for ensuring that everyone who wanted a job could get one. Cue large stimulus bills and massive infrastructure spending plans at the first sign of a slowdown. But today, the challenge has evolved. For a centralized government, transforming a farmer into a bricklayer is not that difficult. Officials can look at a map and say: "We need to build a road here, a bridge there, a power plant near that town, and a subway in this city."

But officials cannot look at the same map and declare: "Let's build a money management business here, a sports marketing business there and an insurance company in this tier-three city." Filling new construction jobs is one thing; creating service industry jobs is another one altogether.

Creating modern service sector jobs can only happen by a bottom-up process

Creating service industry jobs can really only happen from the bottom-up. Governments can put in place conditions that will favor, or discourage, their creation. They can make it easier to register businesses, they can encourage banks to lend to small companies, and they can pass labor laws making it easier to hire and fire workers. But when the chips are down, it is entrepreneurs that grow the service industry, not government investments.

All of this brings me back to Malcom Gladwell's book *Outliers* (see **Outliers And Today's Chinese Youth**). In the dark days of the 1974-75 recession, it would have been hard to imagine the seeds being sown for a transformation of the US and global economies that would unleash huge productivity gains and reshape the world. Yet, as Gladwell makes clear in his book, this is when Bill Gates, Steve Jobs, Steve Wozniak, Scott McNealy and Larry Ellison dropped out of college to set up what would become great engines of "Schumpeterian growth." By the same token, today's world of social media, smartphone applications, voice-over-internet free phone calls and direct messaging was largely born in the wake of the 2008 US mortgage bust.

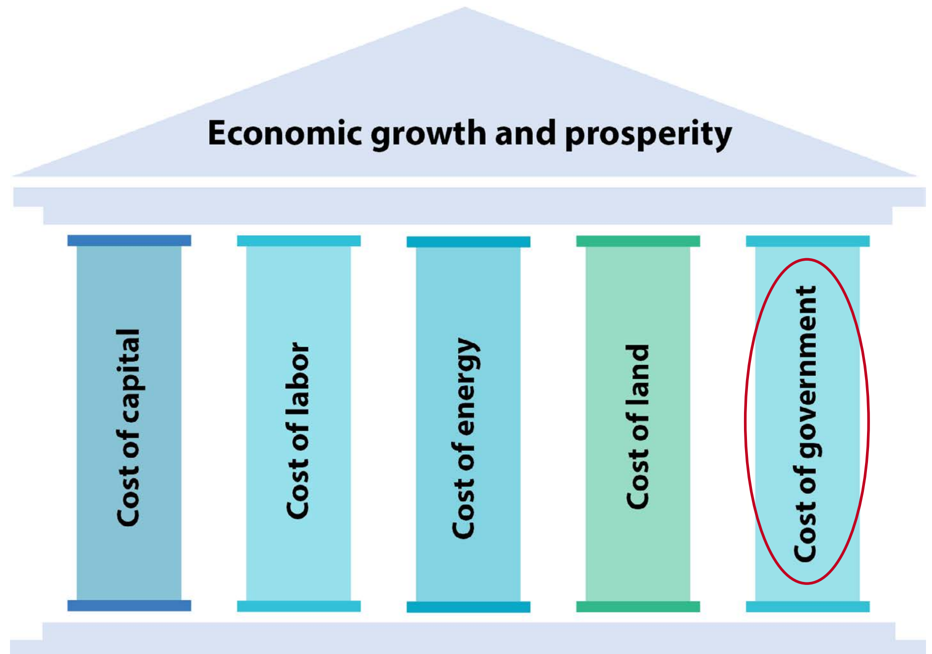
So could the same thing happen in China among today's highly educated but unemployed youth?

China is fundamentally a capitalist economy and there is a high change that many of its graduates in this tough era become successful entrepreneurs

There are several compelling arguments in favor of this outcome. Firstly, China has always been a profoundly capitalist society. As the old Asia hand joke goes: the tragedy of Asia is that Japan is a profoundly socialist country on which capitalism was imposed, while China is a profoundly capitalist country on which socialism was imposed. But keeping nature down is impossible, and so both countries continue to drift back to their natural state. The second is that China's service industry really is "too small" relative to the size of its manufacturing sector, so some rebalancing is bound to happen. The third is just the law of large numbers. As China turns out tens of millions of graduates over the coming years, probability dictates that some of them will prove to be entrepreneurial geniuses.

11) A look through the five pillars

As argued in my post-2008-crisis book ***Too Different For Comfort***, economic growth rests on five key pillars, as shown on the graphic overleaf: (i) the cost (and availability) of capital, (ii) the cost (and availability) of labor, (iii) the cost (and availability) of energy, (iv) the cost (and availability) of land, and (v) the cost of government (it turns out that government is always "available," except when you need it). It is the interaction between these factors that creates (or not!) the conditions for growth, returns on invested capital and prosperity.



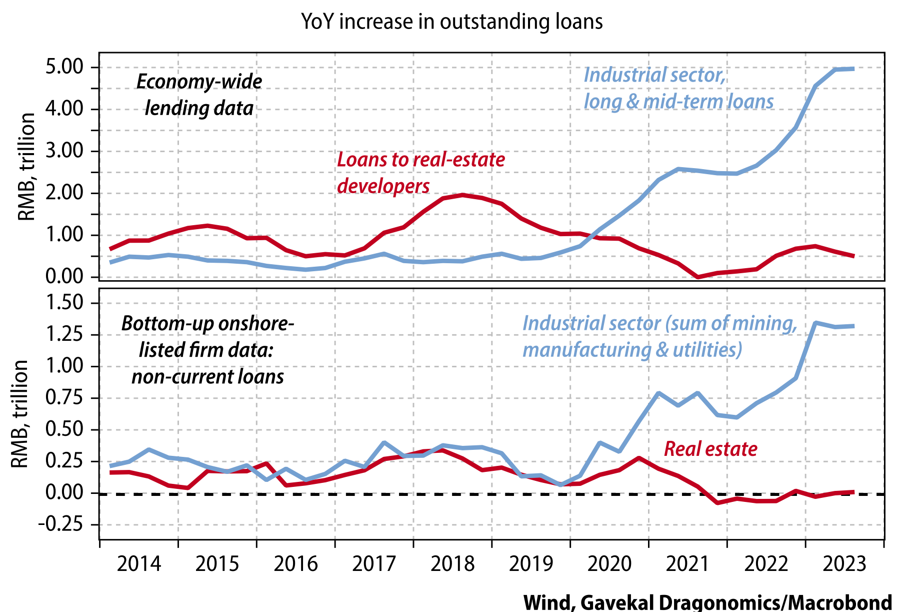
Thinking through these five pillars for China and Hong Kong, one finds that:

Access to bank credit in China for favored industries seems to be accelerating

- **When it comes to capital,** the problem has not so much been its cost as its availability—though only for the key sector of real estate. In recent years, government policy has made it hard to get access to capital to develop real estate, making it prohibitively expensive. However, if one wanted to produce electric vehicles, or electronics, or solar panels, getting access to bank credit at ever-lower interest rates was easy. In fact, access to bank credit now seems to be accelerating (see **Industry Gets A Credit Surge**).

Macro and listed data both show a major rotation in new lending

YoY increase in outstanding loans



Wind, Gavekal Dragonomics/Macrobond

- **When it comes to the cost of labor,** the picture is more complicated, at least relative to a few years ago. A generation back, labor in China was some of the cheapest in the world. For a long time, this was China's main selling point: **the promise of first-world infrastructure matched with**

China's big trade surpluses point to unit labor costs being reasonable

third-world labor costs. This is no longer the case as Chinese workers are now no cheaper than those in Portugal, Greece or Mexico, and much more expensive than workers in Turkey, Tunisia, Vietnam and Indonesia. But as labor costs have risen, so has the productivity of Chinese workers and the quality of its workforce. It is this rise in labor productivity which has helped China to keep running large trade surpluses. After all, to the extent that a trade deficit is a symptom of too high a labor cost (domestic workers earn "too much" and so consume more of other countries' labor), and a trade surplus is a sign of labor competitiveness, today's record-high trade surpluses would seem to indicate that we should not really have too many concerns about China's labor costs.

China's foreign trade surpluses suggest that labor costs are not too high

China is less vulnerable to energy spikes than used to be the case

- **When it comes to the cost of energy,** China is at a disadvantage, for unlike the US, it is not energy self-sufficient. China is today the world's largest importer of oil (despite being the world's sixth largest producer). Still, in recent years it has won more control of its energy destiny. China has done this through large investments in solar capacity—adding roughly as much solar capacity each year as the US currently holds—while building out its nuclear power capacity, laying pipelines into Russia and Central Asia and building up its strategic petroleum reserves. The bottom line is that the days when an oil price spike could derail the Chinese economy—as occurred in 2008—now seem more distant. Moreover, while investors have many reasons to sell China today, concerns over the cost of energy surely can't be one of them since energy prices have been largely rangebound over the last year in spite of multiple different geopolitical tensions.
- **When it comes to the cost of land,** five years ago the high cost of real estate was undeniably an impediment to entrepreneurial activity in both China and Hong Kong. Moreover, the high cost of real estate was starting to prove socially destabilizing. Or at least, it felt that way for those of us who lived in Hong Kong through the largely peaceful "umbrella

protests" of 2014 and the far less peaceful events of 2019. At the time, the unaffordability of housing loomed large amid the reasons for the malaise among Hong Kong's students. Fast forward to today and office real estate is definitely no longer what it used to be and neither are commercial rents. Of course, no one would argue that real estate in Hong Kong or China has become cheap enough to become a mere afterthought. But it is no longer the massive brake on activity, or social stability, that it once was.

- **Which brings us to the cost of government,** or at least its perceived cost. And this is perhaps where the biggest change has occurred. By building infrastructure, overlooking environmental concerns, outlawing strikes and taking down protests, a decade ago investors tended to see China's government as a friend of business. The view was of China's government being part of the solution. Interestingly, a parallel view was that "India grows at night because that is when the government sleeps". Investors saw a competent Chinese government helping to boost productivity, with the mirror opposite situation in India. Fast forward 10 years and that conclusion has flipped, with China's government now overwhelmingly now seen as a big problem (see **Where Now For China's Investibility?**).

China's government is increasingly seen by investors as being part of the problem

12) The cost of government

The cost of government is a tricky matter for there are so many different ways that governments can impact the lives of both people and firms. The obvious ones are taxation and regulation, which are measures by which Hong Kong does well; China less so. But that is hardly the only way that governments can impose a cost upon businesses and populations. At its extreme—and as we are seeing today in Russia and Ukraine—a government can require the ultimate sacrifice from its citizens. But even without going to that extreme, the past few years have shown how governments can lock people down, browbeat them into taking experimental drugs, or shut down businesses.

However, Western economies increasingly have intrusive governments

On this note, before Covid dramatically changed the relationship between governments on the one hand and business and individuals on the other hand, one could argue that **a key comparative advantage of the West was the restraint placed on government action** by constitutions, precedents, or simply decorum. But following the Covid debacle, the freezing of Russian assets and the jailing of Julian Assange, can one still believe this?

This is a topic I have already written at length about (see **Who Is Copying Who?**, **The Guiding Principle Of Our Time**, **CYA As A Guiding Principle (2022)** and **What Freezing Russia's Reserves Means**). At its heart lies a debate about the correct balance between the rights of the individual and the broader interests of the group.

Across the Western world, the rights of the individuals had come, over time, to be placed on a pedestal. As a Catholic, I like to believe that this focus on individual rights reflected the West's Judeo-Christian traditions. As Saint John-Paul II would never tire of saying "God can only count to one" (the parable of the Lost Sheep and all that). And so perhaps it should be no surprise that, as Western societies have increasingly evolved towards some "post-Christian" state, the "north star" of individual rights also got lost along the way? The English writer and philosopher G.K. Chesterton famously said

"When men choose not to believe in God, they do not thereafter believe in nothing, they then become capable of believing in anything." And maybe one of the things men start believing in is that the common good matters more than individual rights? "Trust the science" and all that.

Asian societies have tended to emphasize the interest of the group over the rights of individuals

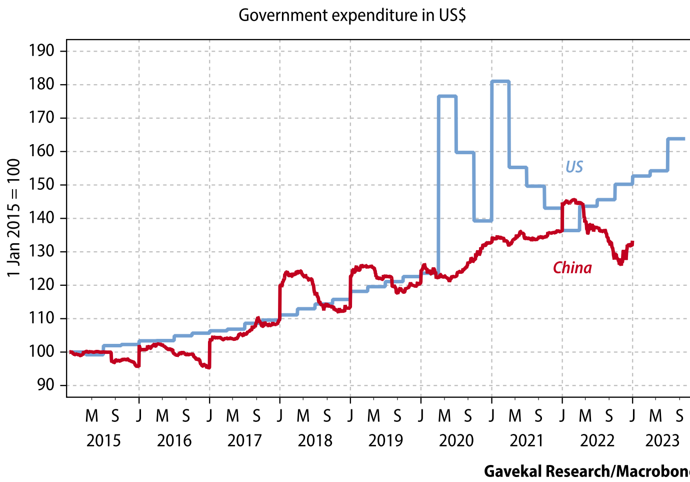
In Asian societies, individual rights have tended to be to be subsumed to the broader interest of the group. This point is seen in traditional Chinese art where landscapes are grandiose and individuals are miniatures whose purpose in the painting is to either represent a task, or highlight the landscape's grandeur. The point can be seen in this Qing dynasty painting that has been displayed at the New York Metropolitan Museum of Art.

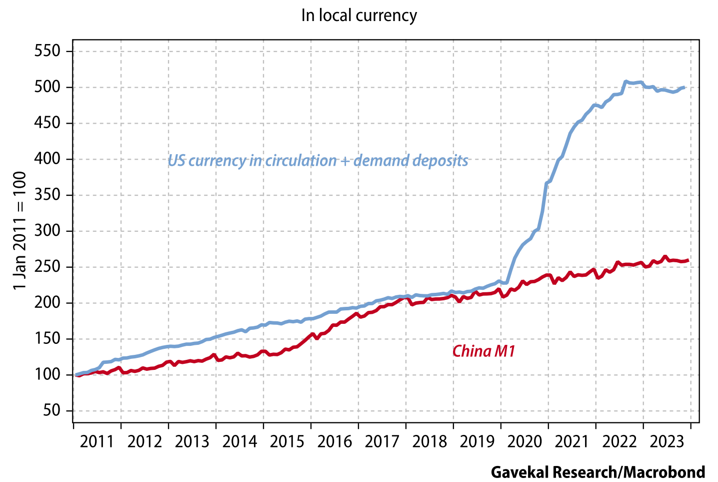
Perhaps the simplest explanation for this is that for centuries most Asian societies were Malthusian in nature as they faced resource constraints, regular famines and epic national disasters. Against such a hard backdrop, perhaps it is natural for the needs of the individual to fall behind those of the group? In such a narrative, as the Western world amassed riches, individual rights blossomed. Meanwhile, most of Asia, and especially China, have only started to become rich in the past five minutes.

The same culture now seems to have pervaded Western societies

Still, when it comes to China, and of course Hong Kong as well, the past few years have been a stark reminder that the interests of the group continue to take primacy over those of individuals (the reaction to protests in Hong Kong and the long Covid lockdowns). But in itself, is that really new information? Looking back at the past few years, the more important change is not how the individual became subservient to the interests of the group in Greater China, as it was ever thus, even before the CCP took power. The more important development is how this is increasingly the norm in the West. If this is right, it would suggest that today's concerns about the cost of government in China (see **Where Now For China's Investibility?**) may be blinding investors to a similar trend across most major economies.

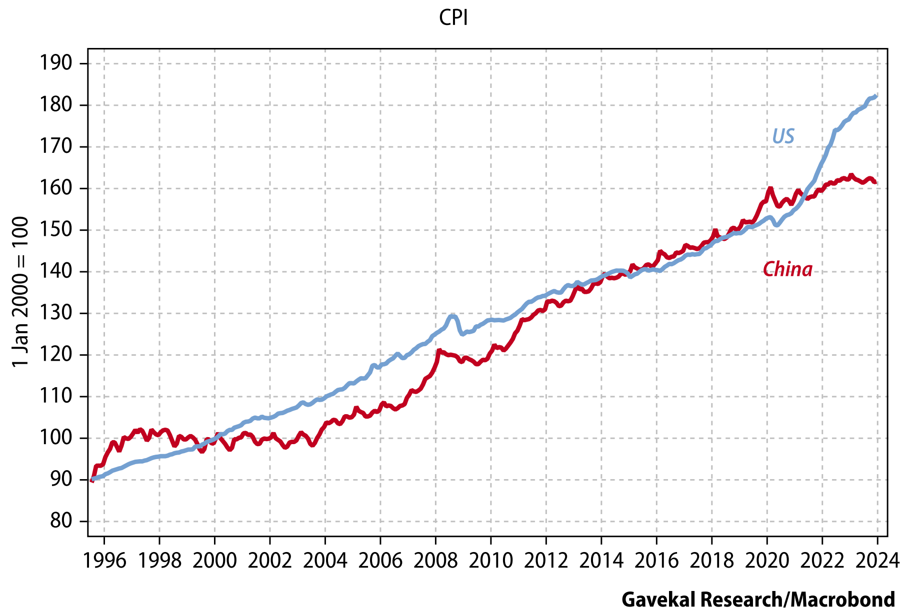
And beyond the restrictions on free speech (see **That '70s Feeling And The Shining City On A Hill**), beyond the diversity quotas and other affirmative action programs, perhaps nowhere do we see this dynamic more at play in Western economies than in today's runaway government spending and monetary printing, as shown in the upper two charts overleaf.





All this money printing and government spending is a "cost of government" for which the bill will come later, probably via higher inflation. In fact, this effect is already starting to form quite a wedge between China and the US.

A wedge has opened up between inflation in the US and in China



And since I went down the religious rabbit hole, I may as well finish this discussion on the relative cost of government between China and the West by quoting scriptures; specifically Matthew 7: 3-5: "Why do you see the speck in your neighbor's eye, but do not notice the log in your own eye?".

Conclusion

I started this piece by looking at the collapse in Chinese equities, the pullback in energy names, weakness in gold mining and copper names and the struggles faced by industrials. The message is that either the Chinese economy is in the process of imploding (option #1), or the year has started with some serious liquidation of positions (option #2) that have in turn pushed a number of the above assets into highly attractive valuation territory.

In fairness, there is an option #3, namely, that the world is entering a wave of unprecedented productivity growth—i.e. a Schumpeterian boom of epic proportions. In such a view of things, the growth of artificial intelligence will allow us to use commodities far more efficiently, and/or extract them from the earth's crust for a fraction of past costs. It would point to an AI boom reshaping economies from the US to India (where stocks also continue to make new highs), Japan (same) and even Europe but bypass China (because of tech restrictions). Such a scenario would explain the continued all-time highs of Nvidia and Microsoft (see **New Highs Or A Double Top?**), the outperformance of the US, and the growing concentration of global equity markets due to winner-takes-all dynamics.

The least likely scenario I see from here is a China implosion

Of these three scenarios, option #1 (the China implosion) actually seems the least likely to me though, interestingly, it seems to be the scenario the broader financial media is pushing the hardest (see **Making Sense Of The China Meltdown Story**). One of the reasons to be doubtful of this scenario is the lack of a follow-through rally in US government bonds. After all, if China really was about to follow Japan's path into a deflationary-bust hell-hole, then global bond yields should be on a path towards new lows.

The media is focused on the onset of a new AI-powered miracle economy that may leave China out in the cold

The option #3 scenario is also a media favorite. And in fairness, it does represent an exciting promise, even if it encompasses two very important unknowns: (i) whether AI can deliver on all these promises and (ii) whether the AI boom will bypass China. After all, before ChatGPT was released, consensus opinion was that China held a big comparative advantage in AI since it had less stringent rules around data privacy than the West, while its tech behemoths can mine much larger swaths of data in an economy that has essentially gone cashless (see **The ChatGPT Challenge For China** and **Trying, Again, To Restrain AI In China**).

The more prosaic explanation for the China market bust in 2024 has to do with investor positioning

This leaves us with option #2, which is the idea that the pullback in cyclical names globally—Chinese tech platforms, energy plays, gold miners—have less to do with important changes in underlying economic conditions, or on the long-term health of these businesses themselves, and everything to do with market positioning. Such bad news can keep on coming (see **The EV Implosion**). But then, structural bear markets rarely bottom out on good news; they bottom out on investor apathy and disdain. As the British economist Arthur C. Pigou once wrote: "Prosperity ends in a crisis. The era of optimism dies in the crisis, but in dying it gives way to an era of pessimism. This new era is born, not an infant, but a giant."