OLD MUTUAL MULTI-MANAGERS

WHEN ELEPHANTS FIGHT

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Probably the biggest shift in the global geopolitical and economic landscape is the changing relationship between the US and China, the world's two largest economies. For much of the previous three decades, the two economies became increasingly intertwined, with China effectively becoming America's factory, while also recycling some of its vast savings into American financial markets. As its own consumer base grew, China also became an extremely attractive market for US multinational firms such as Apple and General Motors. These days, China also has homegrown consumer brands winning global market share, such as Huawei and TikTok.

FROM FRIENDS TO RIVALS

This mutually beneficial relationship has soured. While the overall US economy benefitted, American workers were the big losers from this arrangement, causing great discontentment and ultimately leading to the election of Donald Trump in 2016. He in turn launched a trade war with China in 2018, increasing tariffs to curb imports from China. But there are also internal political shifts in China. President Xi has increased his grip on power, but also steered China on a path of greater self-reliance and assertiveness on the international stage. Rather than being partners, these two great powers are increasingly rivals, and the rest of the world looks on nervously.

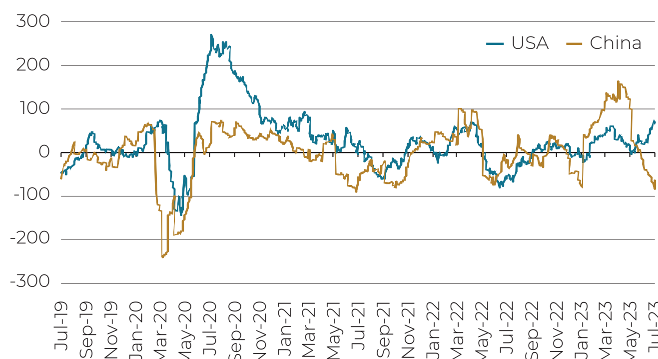
Leaders from both countries want to reduce the reliance on the other side, but they also recognise that a complete decoupling of the US and Chinese economies would be "virtually impossible" as US Treasury Secretary Janet Yellen put it on a recent visit to Beijing, and would destabilise the global economy.

It is clear that this evolving relationship will shape the global economy and financial markets in the coming decades, and much has been written on it elsewhere. What is interesting in the short term, however, is the diverging fortunes of the two giants.

SURPRISE

Surprise indices are a good why of illustrating this. They show how incoming economic data compares with the consensus expectation. In other words, whether the data is better or worse than expected. Chart 1 shows the US and China, the two biggest economies.

Chart 1: Citigroup economic surprise indices



Source: Refinitiv Datastream

American data has mostly been coming in better than expected of late, in defiance of the widespread expectations of an imminent recession. Chinese data initially surprised to the upside as the economy reopened from lockdowns late last year, but recent data has disappointed. In contrast to the elevated and sticky inflation in most parts of the world, China's core inflation fell further in June, down to only 0.4% year on year, while it was 4.8% in the US.

Since the US economy is dominated by consumer spending, that is the obvious place to look. Indeed, the entire global economy is dominated by US consumer spending. It is about as big in dollar terms as the whole Chinese economy.

Estimates vary, but US households still have between $500 billion and $1 trillion in excess savings accumulated during the lockdowns when spending was artificially depressed, and incomes boosted by government stimulus cheques.

The demand for workers remains remarkably strong. There are more job openings than unemployed persons. In June, the unemployment rate was only 3.6% and the economy was adding jobs at an annual pace of 2.5%, while wages (depending on how you measure it) grew at 4% to 5%. This adds up to 6% to 7% annual growth in total worker incomes. Add in a bit of borrowing or a reduction in savings, and there is enough ammunition for consumer spending to continue growing at a rapid clip.

Another surprise perhaps, is the unusual behaviour in the housing market. Because most mortgages have fixed interest rates, anyone who bought a home before 2022 will be extremely reluctant to sell and buy elsewhere today since it means losing a sub-3% mortgage rate in exchange for one that is 6%-plus. As a result, there are very few existing homes on the market for sale. Buyers are forced into the market for new homes, and this is stimulating activity there despite the high interest rates. With the US government now throwing billions at reorientating supply chains back towards America, particularly the manufacturing of

strategically important items like computer chips and batteries, construction of new factories is booming.

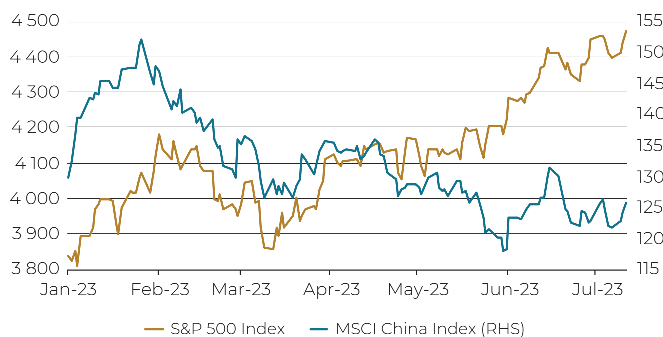
That is not to say everything is hunky-dory. As is the case in China and Europe, the broader American manufacturing sector is under pressure, while the commercial real estate market looks increasingly creaky, buckling under the weight of office vacancies, high interest rates and banks reluctant to roll over loans following the March turmoil in the banking sector that saw three US banks go belly up.

But there is a flipside to all this good news. The strength of American consumer spending means it is not clear that inflation will remain well behaved. Yes, it has declined substantially, but the Federal Reserve wants to have greater confidence that it will stay down once it gets to the 2% target. While we are probably near the peak in the hiking cycle, it still looks like a higher-for-longer rates environment that will ultimately squeeze the economy.

Nonetheless, the US equity market enjoyed a very strong first half. The S&P 500 returned 16% in the first six months, as investor optimism over a soft landing has grown. However, it has also been one of the most concentrated rallies in history, led by a handful of mega-cap technology shares, partly driven by excitement over breakthroughs in artificial intelligence (AI).

The rally this year has been driven almost entirely by a multiple expansion, in other words, a rising price-to-earnings ratio. Earnings are still declining. The fact that this has occurred against the backdrop of rising, not falling, interest rates is reason for caution. Unlike most other global equity markets, the US is trading on the expensive side of fair value.

Chart 2: US and Chinese equities in 2023, US$



Source: Refinitiv Datastream

WEIGHED DOWN

The contrast with China is stark. Unlike the US Federal Reserve, the People's Bank of China has been cutting rates in response to falling inflation and economic disappointment. However, low interest rates cannot stimulate the economy if households and business do not make use of them to increase borrowing. In China this seems unlikely.

Chinese consumer debt as a share of GDP is not high by global standards but has risen faster over the past decade-plus than any other economy, tripling from 20% in 2009 to 60% today. However, because household income is an unusually low share of GDP in China, the ratio of debt to income is similar to developed economies. Again, this matters because it is income that needs to service the debt.

It is true that Chinese consumers also have high levels of savings, meaning there is a cushion. The problem is that as in most other countries, mortgage debt is the largest component of overall Chinese consumer debt, and the asset linked to this debt – residential property – is teetering. House prices have been falling, which makes consumers feel very vulnerable and reluctant to go out and spend. China's consumer confidence index plunged from a pre-Covid level of around 120 points to 85 points late last year. By March, it had only recovered to 94. It is still lower than it was at any point between the start of the survey in 1991 and the onset of the pandemic.

Household debt in China is only a third of corporate debt, which is the real problem area. Much of the debt is linked to struggling property developers, and a fair portion is denominated in US dollars at a time when the renminbi has been falling. Local governments also have large debts and have until recently relied on selling land to developers as a key source of income to service the debt. This is going to be a struggle in future as demand for land dries up.

The world is therefore waiting to see if Beijing will use fiscal policy to stimulate the economy. The risk of doing too much is that the structural problems, particularly excessive leverage and overcapacity, are worsened. The risk of not doing enough is a Japanese style balance sheet recession, particularly since China's population has peaked. As in Japan, demographics will increasingly be a headwind for Chinese economic activity.

The Chinese stock market is therefore under water this year, while the yuan has been falling against the dollar. The Chinese stock market is discounting a lot of bad news, and trades well below its long-term average at a forward price-to-earnings ratio of only 10.

LUCK NEEDED, AND SKILL

2023 is the year of the rabbit in China. The rabbit is considered the luckiest of the 12 animals in the Chinese zodiac. Chinese policymakers will require both luck and skill to handle the short-term economic pressures while dealing with the longer-term challenge of managing its relationship with the US. Conversely, in the US, the most pressing short-term challenge is getting inflation down without causing a recession. Longer term, the US and China will still need to find ways of cooperating, especially to deal with the climate crisis.

For us as South African investors, standing on the outside looking in, these shifts present risks and opportunities. This is not just a source of tension in international relations, but potentially also internally as South Africa's business and finance community tends to look West, while our political leadership increasingly looks East. If the cold-ish war between the US and China escalates into a hotter one, it would require very skillful diplomacy to avoid choosing sides. For investors, managing these crosscurrents will clearly require a cool head and a sound investment process.