

# The China Quandaries

**Louis-Vincent Gave**  
louis@gavekal.com

Given Hong Kong's troubles and the long Covid lockdowns, with Russia's invasion of Ukraine having pushed China from the "adversary" to the "enemy" column in most Westerners' eyes, and with its long equity bear market, few Gavekal clients will have visited China in the past five years. That is a shame, as the country has been transformed in the period.

China has buckets of new infrastructure

First is all of the new infrastructure that has been put into operation: high speed rail lines, freeways, airports and the like. Visitors to Beijing or Shanghai will have become used to first-world infrastructure on past trips. But the fact that Hangzhou, Qingdao, Dalian and other large, but non-first-tier cities, enjoy the same quality of infrastructure is an important development. Sitting at the airport and looking through the departure board, it is fun to see many flights to cities that most non-Chinese people would not recognize.

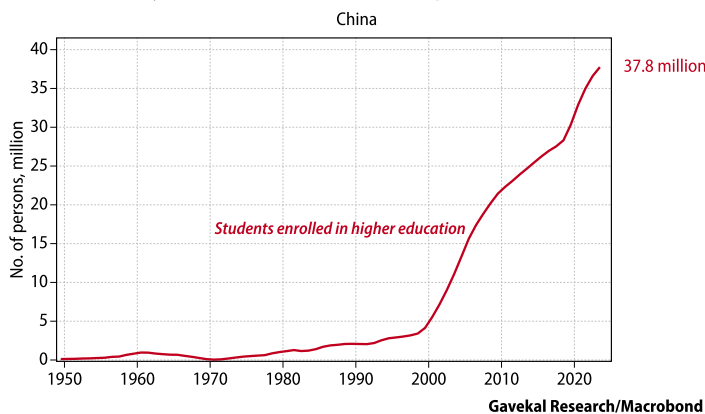
It has also moved to digitize everything

The second big change is the digitalization of everything, to the point where foreigners who do not have Alipay or WeChat installed on their phones find it hard to do simple things like purchasing subway tickets or ordering taxis.

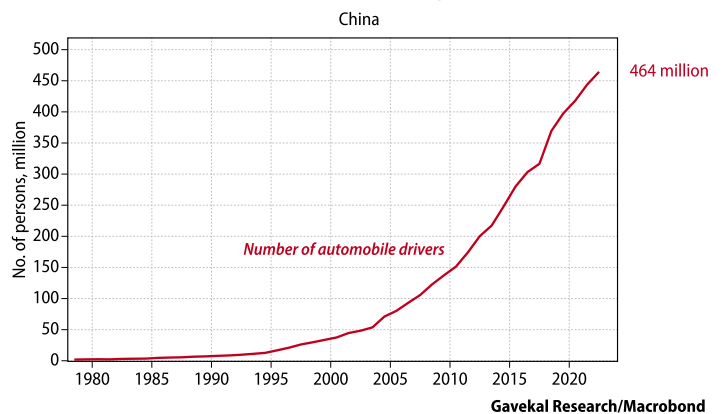
The benefits of mass education are clear

A third impressive change is the number of people who speak decent English. This is perhaps not that surprising since the number of people attending university in China has exploded higher in the past decade, as shown in the left-hand chart below (it is quite helpful nonetheless!).

**University attendance in China has surged in the past decade**



**China has become the world's largest auto market**



Electric vehicles are everywhere

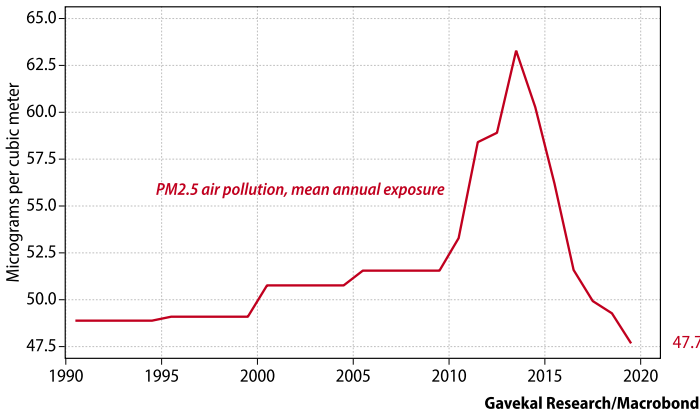
A fourth big surprise is the number of cars on the street (see right-hand chart above), in particular electric vehicles, with the numbers on the street now far higher than in any other country. Also, the fact that there are so many car brands that simply did not exist a decade ago.

Air quality in China has sharply improved

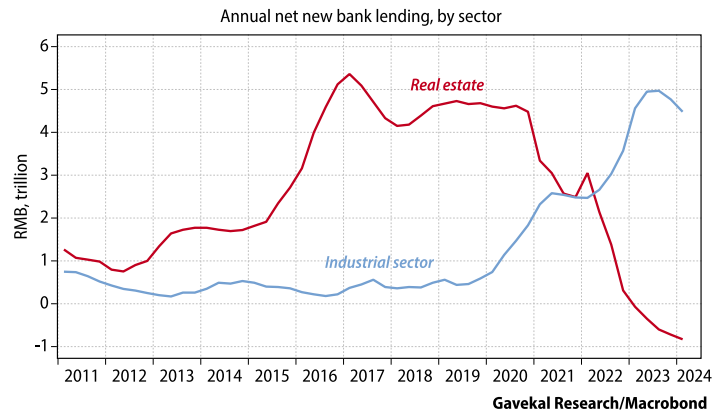
Finally, the fifth surprise is that the urban air pollution is less bad than it used to be, as shown in the left-hand chart overleaf. This is down to (i) the upgrade to China's electricity grid having lessened the reliance on diesel generators and dirty coal, (ii) the EV adoption noted above, and (iii) the sharp slowdown in construction as cement production is highly polluting.

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**China's air quality has improved drastically from the 2010s**



**China's growth policy shuns property in favor of industry**



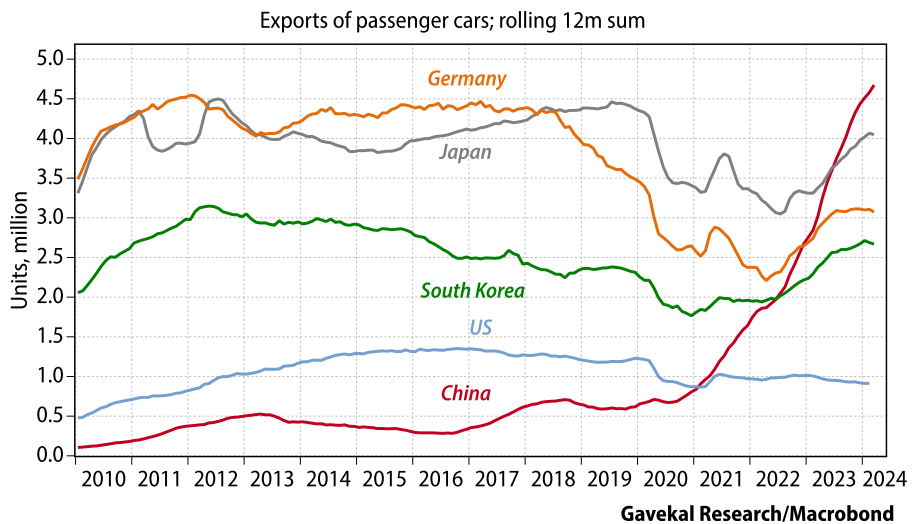
China was forced to invest heavily in order to move up the value chain

On this last point, in the wake of the Hong Kong riots in 2019, China's leaders clearly decided that **relying on real estate for growth risked sowing the seeds of popular discontent and social instability**. Moreover, with the US banning semiconductor exports, China was forced to invest heavily in order to move up the industrial value chain. In an age of great power conflict (see my 2019 book, *Clash of Empires*), China had to quickly cut its reliance on the broader Western world. Banks were thus "encouraged" to forego lending to real estate developers, and instead focus their loans on building up China's industrial backbone, as shown in the right-hand chart above.

As a result, it is becoming a major exporter of high-end industrial products

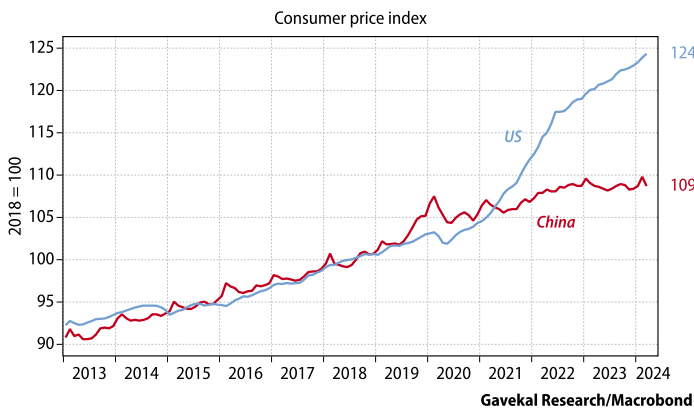
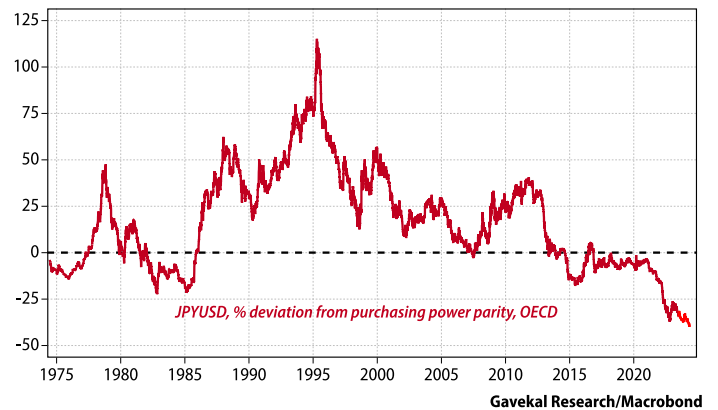
Five years later, China has become a huge exporter of cars, solar panels, telecom switches and railroad equipment. Suddenly, the rest of the world is worrying that China is set to become even more of a deflationary drag on global growth than it has ever been, as it moves to export this new "overcapacity".

**China's cars are heading mostly to new drivers in emerging markets**



This brings me to perhaps the biggest thing that non-travelers to China are missing, **namely, how affordable it has become**. This is especially true in relative terms against any other country (except Japan!), but also against its own history. Indeed, traveling to Beijing or Shanghai in 2018 was not a bargain. But today, Expedia shows that in May, one can stay for US\$175 to US\$300 a night at the St. Regis, Four Seasons, Waldorf Astoria or Rosewood

in either Beijing or Shanghai. Cities like Hangzhou (one of China's most pleasant big hubs), Chengdu (another great Chinese city) or Wuhan (also nice, except in summer!) come in far cheaper—even for luxury hotels of a very high standard. On popular weekends, one would need to add another zero to these numbers to stay in the equivalent properties in London, New York or Paris. For tourists, **China is now a massive bargain**. This is because, while the rest of the world has been experiencing inflation, Chinese prices have been consolidating in recent years, **opening up an impressive gap in value that is hard to appreciate unless one visits**.

**China's inflation has been relatively subdued compared to the West**

**The Japanese yen is cheaper than it has ever been**


China is the economy most directly impacted by a severely undervalued yen

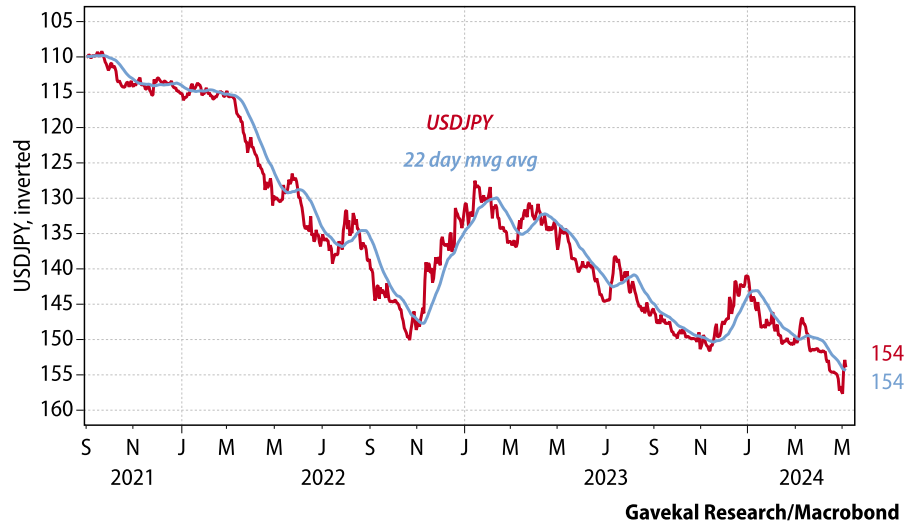
Over the last week, a seemingly choreographed response has helped the yen rally

Success has many fathers. This deflation finds its roots in China's real estate bust, the rollout of industrial investments noted above (car prices have fallen a lot), much improved infrastructure, a rapid digitalization of most consumer services and the upgrading of human capital through secondary and tertiary education. And then there has been the fall in the yen, as shown in the right-hand chart above. Over the past six months, we have spilled much ink arguing that having a G3 currency undervalued by some -40% on a purchasing power parity basis is anomalous for the global economy (see [The Elephant In The Room](#) and [Action, Reaction And The Bull Market In Precious Metals](#)). And of the major economies, **China is the most negatively affected by the absurdly undervalued yen**. After all, if China's strategy is to move away from real estate as a driver of growth, and instead rely on industry and manufacturing, **seeing one of the world's most efficient producers devalue its currency by more than a third is a serious impediment to the plan**.

This brings me to recent events. As the yen went into free-fall, US GDP for 1Q24 disappointed, mostly because of poor trade data. Then, as the yen continued to depreciate, the Japanese authorities seemingly intervened to arrest the fall (see [Can Yen Intervention Work?](#) and [Short And Long Term Questions About The Yen](#)). At the same time, the Federal Reserve did its best to sound, and even act, more dovish. To begin with, the Fed promised a slower pace of quantitative tightening. Then, on the back of weakish jobs numbers, Jay Powell made it clear that he really did not want to raise interest rates again and would like to find a reason—any reason—to cut them. All of this helped the yen mount a rally from its deeply oversold levels and move back above its short term moving average, as shown in the chart overleaf.

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**Are we seeing a turn in the yen?**



In the face of bad news, Chinese equities have proven resilient in recent weeks

Chinese equity markets were hated by investors in the early part of this year

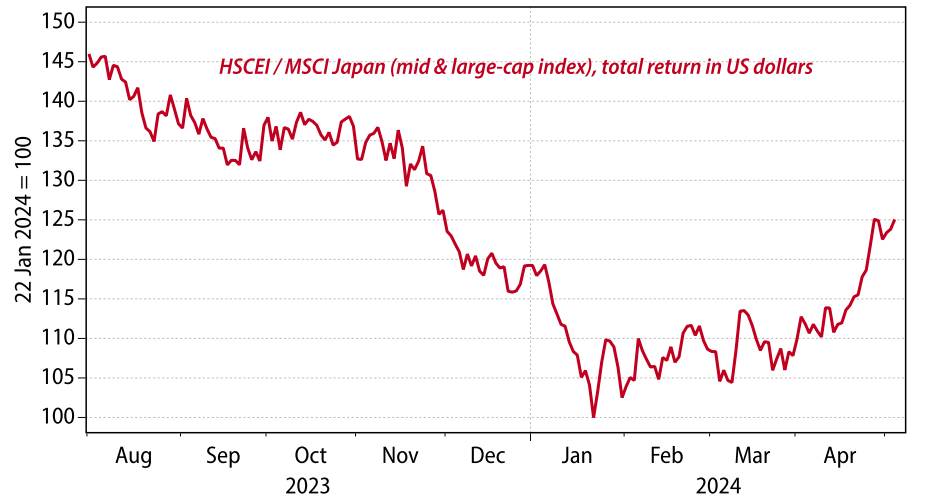
This has left investors with the quandary of **how to efficiently play a hypothetical rally in the oversold, undervalued and underowned yen. So far, the market’s answer seems to be to buy Chinese equities!** In recent weeks, Chinese stocks have ripped higher, even as overall geopolitical news for China was really rather poor (see [Short Answers To Big Questions](#)). A few months back, developments such as the TikTok ban, the arrest of alleged Chinese spies in Germany, the open display of tensions during recent visits by Treasury Secretary Janet Yellen and Secretary of State Antony Blinken would have been enough to send Chinese equities crashing down. **But no longer.**

**Revulsion and capitulation selling**

One could argue that Chinese equity markets were so beaten-up that they were simply due for a bounce. I have argued in the past that while no-one rings a bell at the top of equity markets (i.e. John-Maynard Keynes’s quip that markets can remain irrational longer than one can stay solvent), bottoms are easier to identify. First, there is the pit one gets in the stomach when looking through investment accounts (see [A Personal Note On The Hong Kong And China Equity Meltdown](#)). Then, there are often the valuations that make little sense for anyone willing to project themselves past the next six months (see [Chinese Policy And Chinese Equities](#)), often accompanied by stories of great managers shutting down struggling funds, and thus selling assets regardless of underlying valuations. And then, finally, the broader financial media piles in, all on the same side of the boat. Very clearly, China was ticking all these boxes at the start of this year.

First, on January 23 the Singapore hedge fund Asia Genesis said that large losses on a long H-shares-short Nikkei trade meant it would have to close down. Its statement came pretty much at the market bottom. Had the fund been able to hold on for three more months, it would have made back all of the January and December losses, as shown in the chart overleaf.

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**H-shares made a massive comeback in April**


Gavekal Research/Macrobond

**Once-in-a-generation opportunity?**

Then came the widely viewed column by Stephen Roach in the *Financial Times* on February 11, stating “[It pains me to say Hong Kong is over](#)”. Most people living in Hong Kong took exception to the argument. After all, it is not as if toothpaste in local convenience stores has to be locked away, or as if local office real estate is selling for cents on the dollar and local banks are going bust. Instead, the idea that Hong Kong is “finished” seemed to project the previous five years’ worth of stock market returns and lack of IPOs far into the future. The issue is that those five years were marked by riots and an attempted color revolution, knuckle-headed Covid policies and China’s real estate crackdown. Of course, investors know that Hong Kong’s new national security law makes a repeat of the riots highly unlikely, that a return to Covid lockdowns is a very low-odds-scenario and China is easing both fiscal and monetary policies in a bid to reignite domestic growth. All of this raises the specter that in three years’ time **we look back at the early 2024 period and wonder why we did not fill our boots with Chinese stocks.**

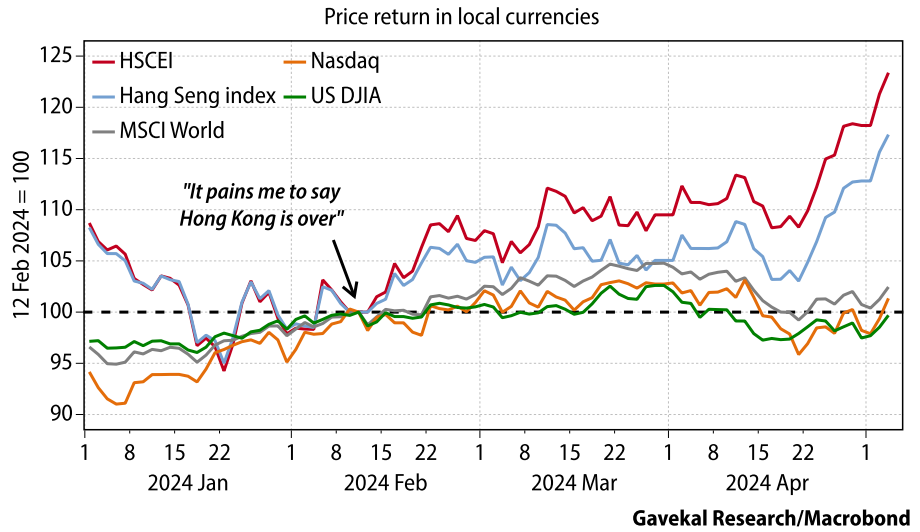
After all, how often can one get companies like Alibaba, Pinduoduo, Tencent, JD.com, Baidu and others (i) growing their cash-flows by double digits, (ii) trading at single digit price-to-cash-flows, (iii) while sitting on cash piles that are typically between a third and two thirds of existing market capitalization, all the while (iv) the government is encouraging companies to do share buybacks, and (v) the government itself intervenes to help put a floor under share prices (see [AI And China: Today’s Dominant Market Narratives](#)).

Perhaps unsurprisingly, since Roach’s article placed a tombstone over Hong Kong’s lifeless corpse, the Hang Seng index has rallied by 18% (see chart overleaf). H-shares have fared even better, bouncing back some 23%, and all this against a backdrop where US equities and global equities (as measured by the MSCI World index) have essentially tread water. So sometimes, “they” do ring a bell at the bottom. Even if, interestingly, most of this rally has really occurred in the past two weeks, as it became increasingly evident that “something” would have to be done about the yen.

The bad news that has hit Chinese equity markets in the last five years is very unlikely to be repeated any time soon

Chinese companies can be bought on incredibly attractive terms just now

**A solid three months for China's beaten-up equity markets**

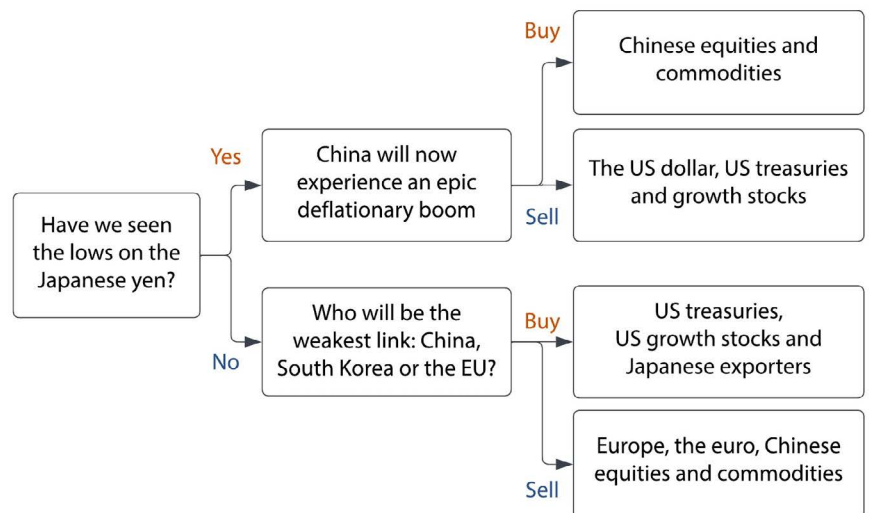


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Global investors are not ready for China enjoying a deflationary boom as everyone thinks it will endure a deflationary bust

This brings me to a simple binary decision tree, which on one side sees the yen move higher against the US dollar, maybe back to ¥140, and perhaps beyond. This may occur for a number of reasons: (i) US growth disappoints, (ii) Japan's government leans on its institutions to repatriate capital, (iii) the broader market starts to price in a Donald Trump presidency that will actively look to depreciate the US dollar, (iv) the Fed starts to ease, or (v) Japanese investors start to fret about US politics and the lack of action to control fiscal deficits. Whatever the reason, the yen starts to move up. **In such a world, it may be that China experiences an epic deflationary boom that wrong-foots global financial markets that are priced for a Chinese deflationary bust.** Instead of falling, the renminbi would rise. Instead of contracting, consumer balance sheets would expand and Chinese consumption would soar, even as Chinese exports (mostly to emerging economies) make new highs. Chinese equities would re-rate and the rebound of the past few weeks would mark the start of an epic bull market. Chinese growth stocks like tech, health care, consumer staples and consumer cyclicals would, in this scenario, do especially well.

**China and the Japanese yen quandary**



My view is that the yen has bottomed out, which raises some interesting questions about the boom now developing in China

Foreign investors have exited Chinese equities on the basis of the market being uninvestible

If China starts to recover, this may not be a major problem for investors benchmarked to global indexes

On the other half of the decision tree is the scenario where recent interventions turn out to be a dud and the yen keeps falling to new lows. In this case, Japan “steals” growth from other countries—notably China, South Korea, Germany, Sweden and other industrial heavyweights. In such a scenario, investors should probably (i) hold on to US growth stocks, which benefit when global inflation rolls over and bond yields stay low, and (ii) buy Japanese exporters.

For what it is worth, I tend to believe that we have seen the low in the yen. But, from painful experience, I also know better than to bet heavily on the decisions taken by Japanese policymakers. As an old Japanese hand taught me early in my career, there are two rules one must always remember when investing in Japan. Firstly, the Japanese population will withstand any amount of pain, if it is believed that the pain makes the community/country stronger. Secondly, there are no limits to Japanese policymakers’ willingness, to test the first rule. Still, assuming that we have seen the lows in the yen, and that our eyes are not lying to us (see [Making Sense Of The China Meltdown Story](#)) and that **China today is actually starting to experience a good old fashioned deflationary boom**, this raises some important questions.

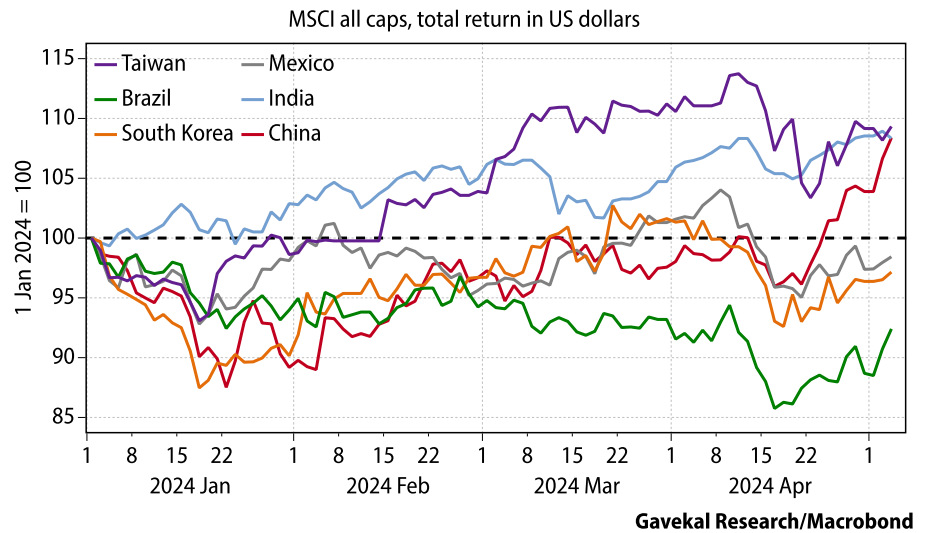
### **1) If the Chinese equity market rally continues, as is usual in a deflationary boom, will foreign inflows start to be seen?**

The one key trend that almost all active managers, from big pension funds on down, have latched on to over the past five years is the idea that China has become “uninvestible”. This trend really started around 2018, when the US ban on semiconductor sales to China was adopted. China then did itself no favors: the crackdown on education stocks, the real estate bust and Jack Ma’s year-long disappearing act helped create an atmosphere in which investors felt the Chinese government, rather than being an ally (preventing strikes, ensuring uninterrupted access to electricity) and a force for growth (building ports, airports, freeways, railways) could be an adversary. Then came Russia’s invasion of Ukraine and suddenly the fear of “being Gazpromed” was born. **One had to get out of China, not out of fear of disappointing returns on capital, but out of fears of the return of capital.** And because China kept stringent Covid restrictions in place, even the most hardened China bulls could not visit companies in the country and so gradually lost interest. The tame post-Covid re-opening, and the US’s shooting down of the “spy balloon” in early 2023 killed off whatever mild interest might have remained.

Throughout this period, being underweight China (i) helped boost relative performance, (ii) corresponded to what most clients were clamoring for, and (iii) left most investors feeling like they were on the right side of history. Today, the latter two pillars may hold, but the first is wobbling. Admittedly, this is not a big issue for investors tracking global equity benchmarks as China does not even make the top five countries in the MSCI All Countries World Index. In itself, this is kind of odd. Is a benchmark really “all countries” when 62% of its holdings are in the US, which itself accounts for 18% of global GDP and 4% of the world’s population? **Yet for benchmarked emerging market investors, the question of China’s relative and absolute performance matters greatly.** In spite of a five-year bear market, China is still the biggest country in the MSCI emerging markets index, accounting for more than a

quarter of the benchmark. So if China starts to perform well, having a zero allocation could become very painful very quickly—especially if, at the same time, other markets do not keep up with a rallying China.

### Many emerging markets' equities are struggling to keep pace with China



As the chart above makes clear, China's stock market only really started to outperform a couple of weeks ago. Up until mid-April, it was still down for the year and performing in line with emerging markets like Mexico, Brazil and South Korea. Moreover, China was lagging far behind the two stars of the year: India and Taiwan (mostly because of Taiwan Semiconductor Manufacturing Co). So China's recent rebound has yet to cause any genuine pain among money managers. Still, China is now outperforming and if this dynamic continues for more than a few weeks, it will duly start to hurt, and perhaps spur some equity reallocations. This raises a quandary: **is a Chinese equity bull market good, or bad, for other emerging markets?**

### What if emerging markets as a whole outperform?

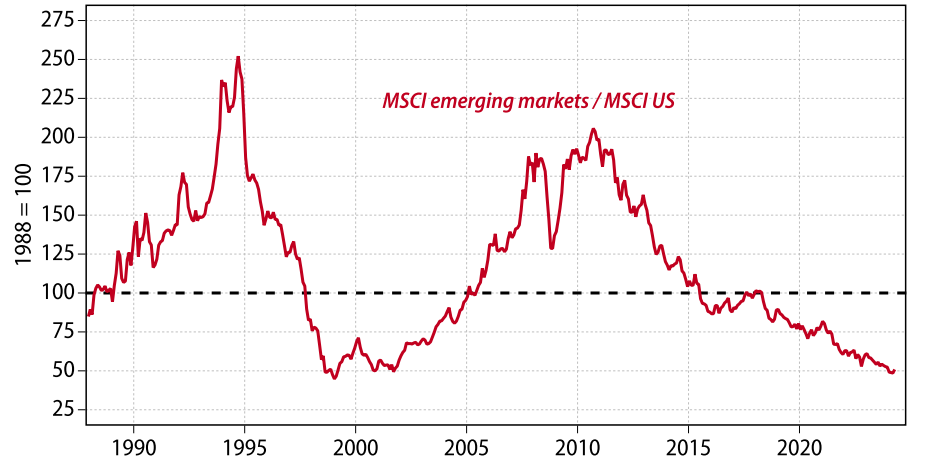
A gut response would have to be "bad news" as money would likely have to leave India, Mexico, Brazil, Indonesia and other recent outperformers to head back into China. China would easily impose a "crowding out" effect on other markets, perhaps similar to the effect the US Magnificent Seven stocks imposed on the rest of global equity markets in recent quarters. Yet, another scenario is possible: that **as China starts to outperform, emerging market indexes start to outperform all other markets and thus spur more capital to flow into the space.** Such a situation would reverse the trend of the last decade, as shown in the chart overleaf. In this case, China's deflationary boom and its resulting equity market rally could start to draw capital away from developed markets—whether the US, Europe or Japan—and into emerging markets. Such a scenario depends on the Chinese equity market's rally continuing, but what if it instead fizzles out?

For dedicated emerging-market investors, a strongly recovering China will be painful for those who are underweight

A strongly performing China may spur a virtuous cycle, where new capital flows into emerging markets, lifting all boats

**US equities are still dominant**

Mid and large-cap, total return in US dollars



Gavekal Research/Macrobond

**2) What could derail the nascent Chinese equity bull market?**

Following the past five years, the honest answer is “so many things”. That could include (i) too early a policy tightening, even if that is not the current direction of travel (see [China Shows Some Policy Flexibility](#)), (ii) the taking down of a prominent business that happened to cross the ruling Chinese Communist Party, (iii) the disappearance of a famous chief executive, (iv) a surprise devaluation of the renminbi that goes against the rhetoric of dedollarization, wrong-footing bullish investors and precipitating capital flight, and (v) another significant downturn in the yen. **Still, of all the concerns, the biggest one has to be geopolitics and the fact that China and the US seem to be at loggerheads on most issues.**

**Perhaps the greatest risk for China would be a sudden Russian victory in Ukraine**, as this would, indirectly, be a loss for the US. In the past 50 years, the US has taken losses in wars that were not vital to its existence, whether in Vietnam, Iraq and Afghanistan. Hence, an indirect loss in Ukraine, where US troops are not involved, could conceptually be brushed aside. The problem is that, in the past, it took a change of president, and even political party, to accept the reality of such a loss: Richard Nixon put an end to Lyndon Johnson’s Vietnam adventure; Barack Obama pulled the plug on the Iraq disaster, and Joe Biden did the same in Afghanistan. However, if Russia were to win in Ukraine before the November election, this would likely trigger anger in Washington, and the search for a culprit. Given that insiders have long described Russia as a “gas station masquerading as a country”, **China could be made to wear the blame for the inability of Western weapons and Ukrainian soldiers to carry the day.** This much was clear in Secretary Blinken’s most recent visit to Beijing. It, thus, seems likely that, should Russian troops advance rapidly between now and November, China could face more tariffs and sanctions from the US. These would be inflationary for a US economy that hardly needs more inflation. But then, as Charles de Gaulle said: “To govern is always to choose among disadvantages”. Failing that, governing can also be about finding credible scapegoats for failures.

A wide range of macro developments could upend the Chinese equity recovery

Perhaps the biggest risk to the Chinese equity rebound would be American blowback should Russia win in Ukraine

The key indicator to watch in the coming weeks will be the direction of the yen

Investors are advised to protect their positions with option strategies given the binary nature of likely outcomes

## Conclusion

The direction of the yen over the coming weeks will be key to the performance of markets for the rest of the year and beyond. A higher yen will see emerging markets outperform developed markets, pushed higher by a very attractively valued China—a China that is widely expected to experience a deflationary bust but increasingly shows signs of a nascent deflationary boom. Such a Chinese boom would be the result of investments made in people (education, health care, environment) and infrastructure (rail, electricity grid, canals) and represent the fruits of trees planted over the past generation. On the flip side, a lower yen would see the 2023 investment environment continue, except that US treasuries may do better and the euro could collapse.

Given the binary nature of such developments, expressing the above views through options may make sense. Investors are advised to stay long Chinese equities, but also buy out-of-the-money puts on the euro should the yen devalue once again. Indeed, while yen volatility has been quite high of late, thus making options expensive, volatility in the euro exchange rate has been far more muted. And if the yen breaks down to new lows, which is not my base case, I struggle to see how the euro does not follow suit.