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ALL EYES ON CHINA!

US Fed Policy Direction is Now Controlled by China

ANALYTIC INSIGHTS: DRIVERS

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US Fed Policy Direction is Now Controlled by China

Have you been paying attention to the drama going on between the US$ and the Yuan or more specifically between US and Chinese Monetary authorities?

THE PROBLEM

The Chinese hard landing problem is twofold.

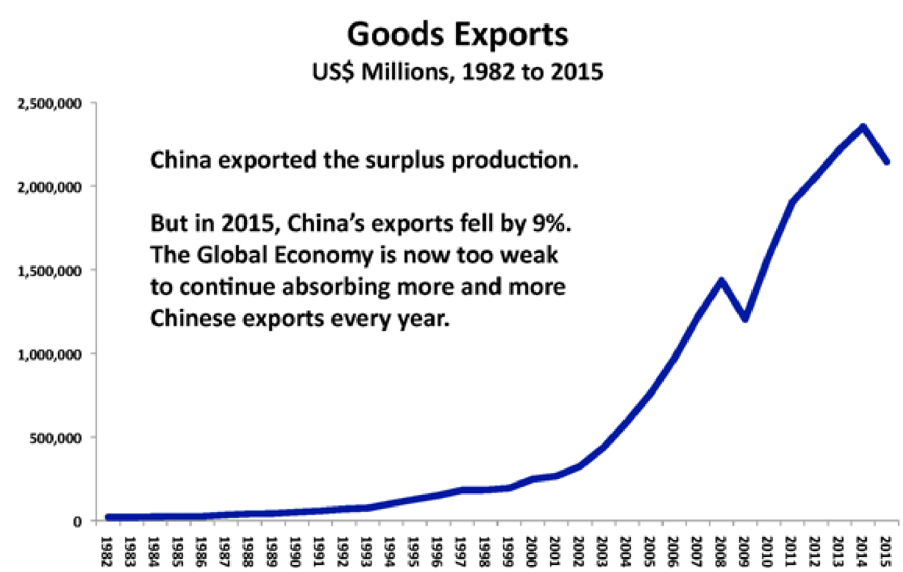
PROBLEM #1 - An A Economic Surplus the World Can't Absorb

First, China has an economic surplus. That surplus is defined economically as Chinese Production less Chinese Consumption. Unlike the US, China produces significantly more than it consumes. That is a tremendous economic advantage if that surplus can be absorbed by the rest of the world!

But what happens when that surplus can't be absorbed?

That is what is occurring today as global trade slows dramatically and China finds itself with excess capacity and decreasing pricing power against competition facing the same dilemma.

This normally means reducing production capacity, downsizing of the labor force, reduced supplier commitments and even bankruptcy. A process Americans are well acquainted with.

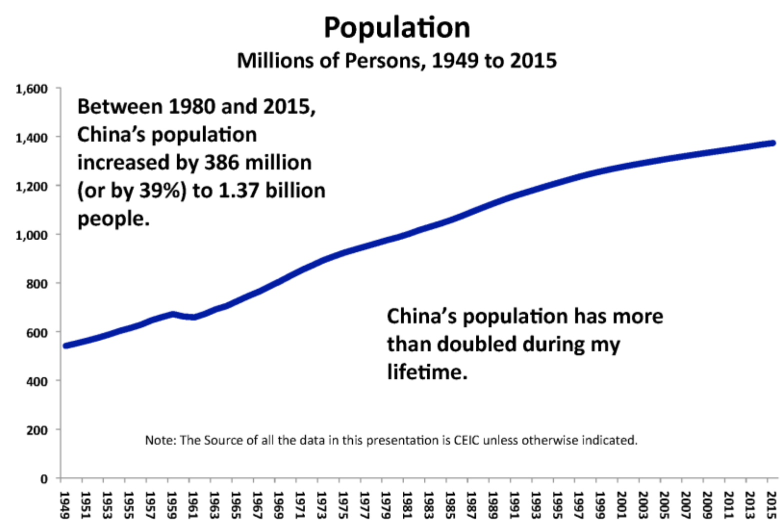


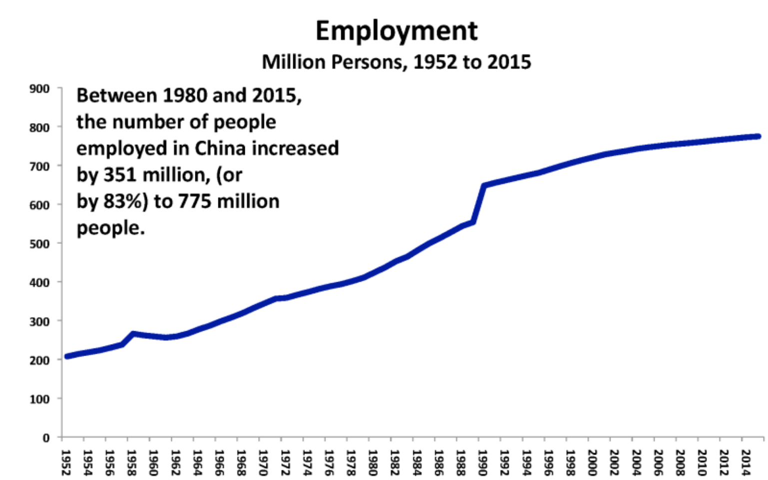
Unfortunately, layoffs are not the Chinese way. This is because the government is expected to supply workers with jobs. No excuse – that is the expectations people have from their government.

Between 1980 and 2015, China's population increased by 386 million (or by 39%) to 1.37 billion people. That growth is larger than the US entire population.

What is truly astounding is that above all else, what China needed most over the past three decades was jobs to employ those people as 50M people left the rice paddies looking for urban work to support their families.

China succeeded brilliantly. It created 351 million jobs during that same period of time - an accomplishment of historic proportions. This was an 83% increase taking the work force to 775 million.



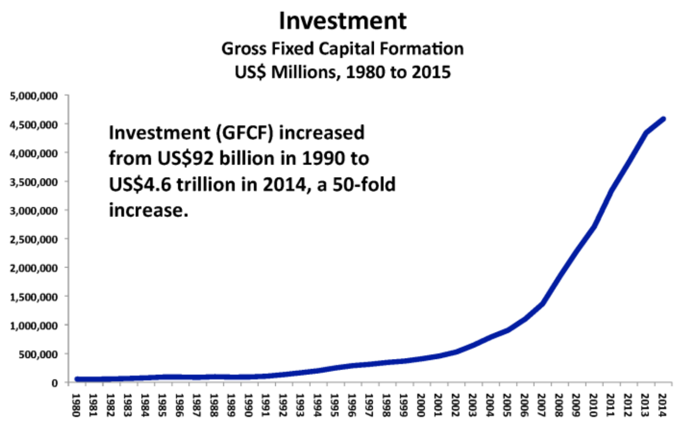


The question that needs to be asked is how sustainable are those jobs?

Unfortunately, to do this China had to make strategic decisions that are coming back to haunt them.

The Chinese government chose to allocate massive capital and credit towards investments in construction.

Let's examine the magnitude of those investments and the dependency jobs are on sustaining even building on this rate.

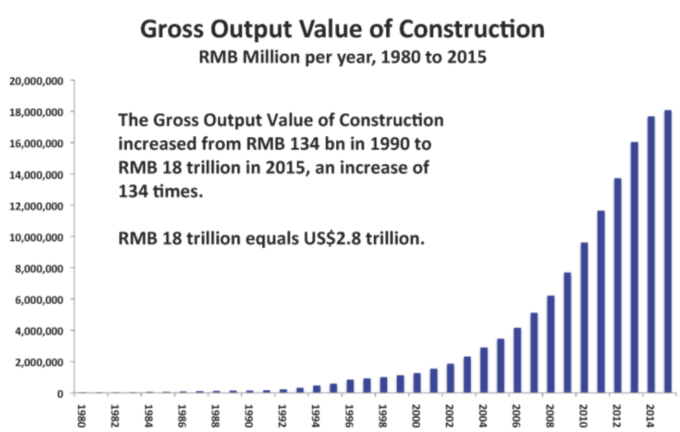


CONSTRUCTION

Unprecedented growth in construction major infrastructure projects such as Railways, Highways, Subways, Airports, Power Generation and Telecommunications.

Building area under construction increased from 380 Million sq m in 1990 to 12.5 Billion in 2015. That is a 33 times increase or an average growth rate of 15% a year between 1990 and 2014.

Between 1995 and 2014 floor space under construction increased by 15 times for Residential space, 6 times for Office space and 14 times for Commercial space.



Cement production for example as a consequence increased from 210 million tons in 1990 to a peak of 2.5 billion tons in 2014. This was a 12 times increase or an average 11% per year. From 2011 to 2013 China produced more cement that the United States did during the entire 20th century. 59% of global cement capacity.

Steel production increased from 66 million tons in 1990 to a peak of 822 million tons in 2014, a 12 fold increase. China now has 50% of global steel production capacity. The capacity utilization rate for steel production globally is only 65% currently leaving 35% unused.

I could expand further but you can see the magnitude of what occurred. Ghost cites and malls were built with no cash flows to justify the expenses. These may be investments that the government may be able to absorb but private Enterprise can't survive and certainly can't survive if construction was to slow down or shrink?

Jobs are in jeopardy and something will soon need to be done.

"What is unsustainable will not be sustained!" Will Rogers

PROBLEM #2 – Dependency on Foreign Capital Investment

I mentioned earlier that China had two problems.

The second problem is China's dependency on massive Foreign Capital Investment.

The spectacular Chinese growth engine was also a result of growth from foreign capital investment, as factories were built by private corporations to capitalize on global labor arbitrage.

This was the second big producer of those critical Chinese jobs.

This story everyone in the world is familiar with but few appreciate that these same factories are now under tremendous pressure to automate in attempt to stay competitive by reducing labor costs as pricing power is lost. As cheap as labor may be in China, with capital so cheap globally it forces Chinese investment in labor savings robotics and automation.

United States & China
GDP Breakdown 2009

	United States	China
Personal Consumption Expenditure	71%	35%
Gross Fixed Capital Formation	16%	45%
Net Exports	-3%	4%
Government Spending	17%	13%

Capital Investment and slowed dramatically and as a matter of fact capital is leaving China for fear of what may lie ahead.

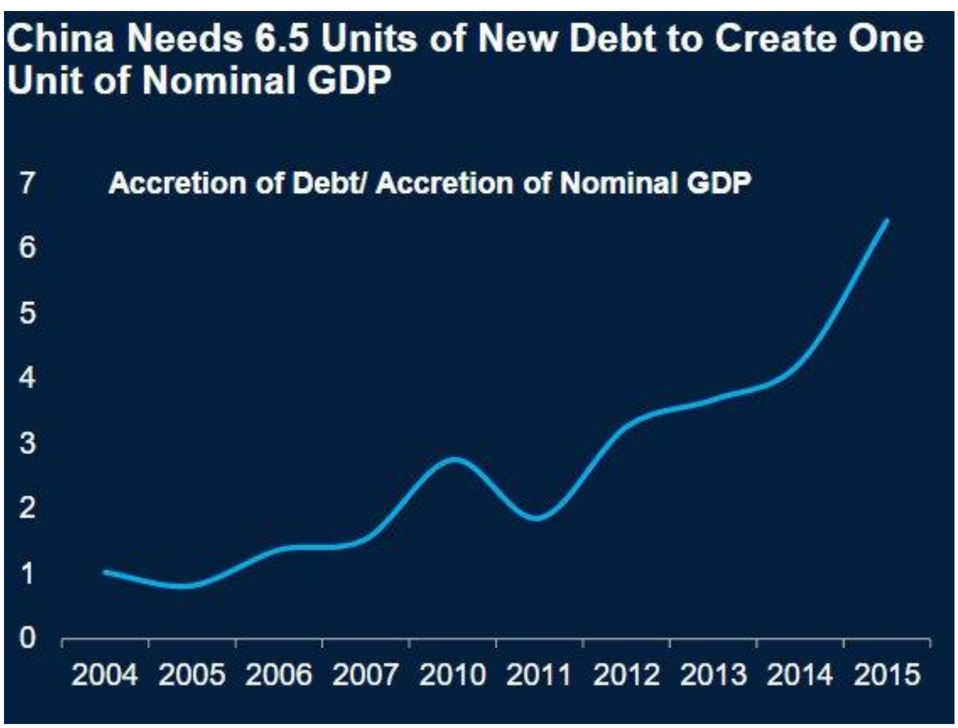
The global slowdown has robbed china of growth in excess FX Reserves to fund massive government job creating projects and has additionally, reduced capital flows to finance more factories. Both are critical to China's political survival.

What can the Chinese government do?

SELL CHINESE FX RESERVES

China has already resorted to selling down its FX Reserves to assist with economic credit funding.

Unfortunately, the amount of debt funding China requires has become horrendous. China now needs 6.5 times Debt to GDP. This is mountain too high to climb even if the RRR (Required Reserve Ratio) was increased from 16.5 to north of 20. In reality another alternative must be found.



DEVALUATION

The immediate resolution is for China to reduce the value of the Yuan to attract foreign capital and additionally make its manufactured products even more competitive as well as potentially sustain demand.

China has attempted four times in May to reduce the Yuan with little success compared to the actions it took in August 2015, which rocked the global financial markets. They are clearly holding back and these are only warning salvos for the US to take appropriate policy positions and actions.

You can be assured that the upcoming June 6th U.S.-China Strategic & Economic Dialogue is going to be critical in the determination of the role US Monetary Policy is going to play in assisting with China's dilemma.

If the US proceeds with it planned rate hikes the US dollar is likely to strengthen which will weaken the Yen and Euro. The EU is a major concern to China since the EU is China's largest trading partner. A US rate hike is likely to also continue to put pressures on commodities and Emerging Market economies. None of this is good for China.

SHANGHAI ACCORD

The February 2016 G-20 Shanghai Accord has broken down and something more durable must be put in place before the June FOMC meeting.

Expect the unexpected but traders should keep a close watch on Chinese statements, the Yuan and Fed policy as it impacts the US dollar!

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