Yardeni Research

October 22, 2024

Morning Briefing

On China & The Dollar

Check out the accompanying chart collection.

Executive Summary: Chinese stocks surged in response to the government's stimulus plan in September. The government has done little to please investors since. China would be better off stimulating consumer spending via "helicopter money," Eric explains, rather than trying to boost asset prices and increasing lending. … Also: The US dollar has been strong over the past month. Is that strength sustainable? Yes, we believe, although there are plenty of moving parts in the US and abroad with bearing on the greenback's value.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

China: Any More Stimulus? The Chinese government has spent the past month scraping together measures to stimulate its economy. The rapid rally in Chinese stocks that kicked off on September 24 has stalled. The Shanghai Composite is up 21% from its September lows as of Tuesday, but off 6.4% from its highs two weeks ago. The Chinese benchmark index is up just 10% this year; that's about how much it's risen over the past five years as well (*Fig. 1*).

Investors want the Chinese Communist Party (CCP) to provide direct fiscal stimulus to households to combat headwinds such as deflation, the negative wealth effect, an aging labor force, and weak consumer spending. That type of stimulus might be too socialist even for the CCP, despite its effectiveness here in the US.

Let's discuss the latest developments in China and why investors who went "all in" on Chinese stocks a few weeks ago have been disappointed thus far:

(1) *Helicopter money still MIA*. Consumer confidence has plummeted in China (*Fig. 2*). Consumer spending is falling as a result (*Fig. 3*). But the Chinese government's response has attempted to refuel consumer optimism via boosting asset prices rather than handing consumers cash. It will take time for the property market to clear, and likely too long for

asset values to recover enough for consumers to start shopping again soon.

Kickstarting consumer spending with helicopter money seems to make more sense, but President Xi Jinping apparently lacks the will to provide direct fiscal stimulus. The easing measures employed instead target financial markets and assets, such as reducing interest rates and lowering bank reserve requirements. On Monday, the People's Bank of China (PBOC) cut its benchmark one-year loan prime rate (LPR) and five-year LPR by 25bps, to 3.1% and 3.6%, respectively (*Fig. 4*). The Chinese government also has offered $71 billion of leverage to brokers and insurers to buy stocks.

Fiscal measures, on the other hand, have mostly tried to stoke demand in the property market. The Chinese government has lowered mortgage rates as well as down payments on second homes and is providing financing for local governments to purchase homes from developers. That sounds like stemming the bleeding rather than instigating a recovery. Even those measures aren't receiving much of a hurrah: A $562 billion loan quota for residential real estate projects spooked property stocks late last week after falling short of expectations, *Bloomberg* reported (*Fig. 5*).

It appears that the CCP is not pivoting its economic development model but rather trying to avert a deflationary crisis. The *WSJ*'s Chief China Correspondent wrote on *October 15*, "For Xi, the officials and advisers say, the near-term goal isn't to massively stimulate demand but to fend off a brewing financial crisis—or 'derisking,' in official lingo—thereby helping to stabilize the overall economy and achieve the 5%-or-so growth target for this year."

(2) *The cure for too much debt is more debt?* Xi prefers to shore up the balance sheets of local government financing vehicles (LGFV) so they can continue to fund projects across the country using debt. The issue is that these LGFVs are already highly indebted.

Bank loans in China total roughly $36 trillion, roughly double China's 2023 GDP (*Fig. 6*). However, an additional $7 trillion to $11 trillion in loans are estimated to be off the books, according to the *WSJ*, residing in places like LGFVs. Many municipalities overleveraged themselves by lending to dead-end projects just to meet China's growth targets. Now they are stuck with low to no returns and debt overhangs that prevent continued lending. Total social financing has fallen from a peak of $3.4 trillion in the 12 months ended April 2023 to $2.5 trillion in the year ended September (*Fig. 7*).

(3) *The vote from the commodity pits*. Commodity traders in London, Chicago, and across the globe are giving a vote of no-confidence to the CCP's efforts to shore up domestic

growth. The price of copper, which is very sensitive to manufacturing and construction activity in China, is still trading below $4.50 a pound (*Fig. 8*). The price of oil has remained unperturbed, and that's including the growing geopolitical risks in the Middle East (*Fig. 9*).

(4) *Yuan matters*. The Chinese government announced its first flurry of stimulus on September 24, less than a week after the Federal Reserve's 50bps rate cut. That's because if China eased monetary policy too much while the Fed stayed tight, it would risk devaluing the yuan too far (*Fig. 10*). A cheaper yuan fuels exports, sure. But foreign capital could flee the country as Chinese rates aren't attractive relative to other countries. That's what happened as global central banks raised interest rates in 2022 and 2023 (*Fig. 11*). Only this year did investors start to bring cash back.

China likely has not been able to provide a "bazooka" of stimulus over the past month, as expectations for Fed rate cuts have shifted. Economic data in the US have been stronger than the consensus expected, and now futures markets see just five Fed rate cuts within the next 12 months, down from nearly 10 in September (*Fig. 12*).

If the Fed becomes more hawkish, China's ability to ease may be limited.

(5) *China buying gold*. China has increased its gold purchases since Russia invaded Ukraine, likely looking to safeguard its reserve from potential sanctions (*Fig. 13*). The price of gold has climbed 33% ytd to a new record high of $2,750. Global central banks, particularly those of countries unfriendly to the US, have been buying gold for their reserves since the US enacted heavy financial sanctions on Russia in 2022 (*Fig. 14*).

Currencies: Is the Dollar's Rebound Sustainable? The US Dollar Index (DXY) has risen 2.9% over the past month. The greenback has been aided by strong economic data that have boosted Treasury bond yields and reduced expectations for Fed easing. How long the dollar remains strong may depend as much on the US as other countries. Broadly speaking, we expect the greenback to remain strong.

Consider the following:

(1) *Global central banks*. Last week, the European Central Bank cut rates by 25bps to 3.5%, its third such cut this year (*Fig. 15*). Meanwhile, the Bank of Japan has shed its temporary hawkish stance and looks primed to keep rates ultralow for the foreseeable future. With two major central banks easing policy (or maintaining easy policy), even a couple more 25bps cuts by the Fed would preserve a sizable gap between domestic interest rates and those in

advanced foreign economies (AFEs).

(2) *Petrodollar*. The DXY has been tightly correlated with the price of crude oil since the pandemic (*Fig. 16*). That makes sense, as the US is now a net exporter of oil and brisk US spending on imports has aided global growth (*Fig. 17* and *Fig. 18*).

While the price of oil and the value of the dollar benefit from strong growth, they also benefit from geopolitical instability. Should the war in the Middle East bring Iran and Israel into direct conflict, then fears of lower oil supply would raise oil prices, while investors would rush into the dollar for safety. The BRICS (Brazil, Russia, India, China, and South Africa) and OPEC+ could also find ways to cap energy supply, similar to what occurred in the 1970s.

Our Roaring 2020s economic scenario (50% subjective odds) sees the US outperforming thanks to strong productivity growth. That should benefit the dollar. Our meltup scenario (30%) sees profligate fiscal spending and over-easy Fed policy driving inflation expectations higher. That boosts the dollar. Our geopolitical shock scenario (20%) sees a rush into dollars as a hedge.

Major risks to the dollar include a black swan event affecting the US economy more than the rest of the world and, more likely, the presidential election not settling smoothly. While we are mindful of those risks, we are far from turning bearish on the US economic outlook because of them. Our outlook suggests the dollar's value should hold up relatively well.

(3) *BRICS*. The emerging markets' version of the G-7 convenes in Russia on Tuesday. The BRICS will also be joined by the UAE, Iran, Ethiopia, and Egypt. Ideally, the BRICS would like to create a payments and financial system away from the dollar and independent of potential sanctions from the West. We don't see that idea supplanting the dollar anytime soon.

Since the US booted Russia from the international payments system known as "SWIFT" in 2022, trade among Russia, China, and other developing countries has surged. But that's unlikely to uproot the dollar's de facto reserve role. More than 58% of global foreign exchange reserves are held in dollars (*Fig. 19*). While that is down from 72% at the start of the century, that's mostly because the emergence of the euro has allowed reserve managers to diversify. We do not expect the dollar's share to fall meaningfully further.

Even the euro has fallen from roughly a quarter of global foreign exchange reserves a decade ago to just a fifth today. The yen and other AFE currencies have filled the gap. The Chinese renminbi is just 2% of global reserves despite China's major role in global trade.

While gold reserve purchases are in vogue, the bigger challenge for the BRICS is the dollar's role in trade. According to the *Atlantic Council*, roughly 54% of global trade is denominated in dollars, and 88% of foreign exchange transactions involve dollars.

Fed *research* shows that in the two decades ended 2019, the dollar accounted for 96% of trade invoicing in the Americas, 74% in Asia-Pacific, and 79% in the rest of the world excluding Europe (where the euro naturally is used more often).

Moreover, supplanting the dollar's role with Chinese renminbi would be nearly impossible, as the renminbi is pegged by the state, has two competing markets (onshore and offshore), and is not joined by a highly liquid sovereign debt market like US Treasuries.

In short, the features of the US monetary system that make the dollar so desirable are likely to remain in place.

Calendars

US: **Tues:** Richmond Fed Manufacturing Index -21; Harker. **Wed:** Existing Home Sales 3.88mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Beige Book; IMF Meetings; Barkin. (Trading Economics estimates)

Global: **Tues:** G20 Finance Ministers & Central Bank Governors Meeting; Lagarde; McCaul; Lane. **Wed:** Eurozone Consumer Confidence -12.0; Lagarde; Bailey; Lane; Breeden. (Trading Economics estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Just one of these three indexes had forward earnings move higher during the October 18 week. LargeCap’s forward earnings rose for a third week to a record high after falling for two straight weeks for the first time since December, when it fell for three straight weeks. LargeCap snapped its 37-week streak of record-high forward earnings high during the September 13 week, which was its lengthiest string of weekly record-high forward earnings in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's fell 0.1% w/w to 2.0% below its record high in early June 2022. SmallCap's dropped 0.1% w/w to 11.3% below its mid-June 2022 record. Through the week ending October 18, LargeCap's forward earnings has soared 19.1% from its 54-week low during the week of February 1, 2023; MidCap's is 6.7% above its 55-week low during the week of March 10, 2023; and SmallCap's is 2.7% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's has improved faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (9.1%, 14.2%), MidCap (-1.1, 16.0), and SmallCap (-9.8, 17.8).

S&P 500/400/600 Valuation (*link*): Valuations rose during the October 18 week for these three indexes to multi-year highs. LargeCap's forward P/E rose 0.2pt w/w to a 42-month high of 21.8 and is 1.7pts above its 14-week low of 20.1 during the August 9 week. It's also up 4.8pts from a seven-month low of 17.0 during the October 27, 2023 week and 6.5pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.2pt w/w to a 35-month high of 16.3 and is up 4.0pts from a 12-month low of 12.3 at the end of October last year. These compare to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E rose 0.3pt w/w to a 35-month high of 15.8. It's up 5.3pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 25% discount to LargeCap's P/E is up from a 25-year-low 29% discount during the July 5 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 28% discount is up from a 24-year-low 34% discount during the July 5 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

US Economic Indicators

Leading Indicators (*link*): The Index of Leading Economic Indicators (LEI) fell again in

September, sinking for the seventh straight month, by 0.5% in September and 2.8% over period. The LEI has plunged 15.9% from December 2021's record high, falling to its lowest level since May 2016. Over the six-month period between March and September 2024, the LEI fell 2.6%, steeper than the 2.2% drop over the six-month period between September 2023 and Mach 2024. The Conference Board notes, "Weakness in factory new orders continued to be a major drag on the US LEI in September as the global manufacturing slump continues." Of the 10 component of the LEI, four contributed negatively, while five contributed positively, with the average manufacturing workweek unchanged. New orders (-0.20 ppts) was the largest drag on the LEI, followed by the interest-rate spread (-0.18), building permits (-0.09), and consumer expectations (-0.07). Partially offsetting those declines were stock prices (+0.11) initial claims (+0.04), leading credit index (+0.3), nondefense capital goods orders ex-air (+0.01), and consumer goods orders (+0.01).

Coincident Indicators (*link*): The Coincident Economic Indicators (CEI) index increased for the fifth consecutive month, by 0.1% in September and 0.9% over the period to a new record high. The CEI expanded 0.9% during the six-month period ended September 2024, above its 0.5% growth rate over the previous six-month period. Three of the four components of September's CEI—payroll employment, personal income less transfer payments, and manufacturing & trade sales—once again contributed positively to the CEI last month, slightly offsetting the decline in industrial production, which was a major contributor to growth in August, following July's decline in output.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Eric Wallerstein, Chief Markets Strategist, 201-661-3575
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-241-6502
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102