SPECIAL REPORT

CHINA AND THE GLOBAL ECONOMY

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Of greatest concern is China's overbuilt and highly leveraged real estate sector. Property developers have entered a multi-year deleveraging phase as policymakers attempt to limit financial risks associated with a highly speculative and debt-ridden housing market. Real estate investment has been a major engine of Chinese growth for many years but is currently in a downtrend that could persist throughout this year, at a minimum.

Economic conditions within China continue to deteriorate at a worrisome pace, with potentially significant repercussions for the world economy and financial markets. In addition to daunting long-term structural problems that could take many years to resolve, the Chinese economy faces several formidable challenges that could have major economic and financial implications for 2022. This Special Report outlines the economic challenges facing China and the potential implications for the global economy.

- China's economy is faced with a serious medium-term growth problem. GDP growth has been in a decelerating trend in recent quarters; fourth quarter GDP growth of 4% was below the government's target of 5%, with the rate of growth slowing to near zero in December. All key indicators signal a continued loss of economic momentum as 2022 unfolds, with all traditional sources of growth facing massive headwinds.

- Faced with widespread weakness in domestic demand, the Chinese economy has been driven primarily by export trade in recent quarters. Exports rose by 20% last year — led by a surge in US imports — boosting domestic manufacturing and pushing China's trade surplus to an all-time high. Industrial production rose by 8% last year but slowed to only 4% in Q4. All other key sectors are currently in a state of decline.

- More than one-quarter of 2021 GDP growth was attributable to exports, primarily exports to the US, but the outlook for this year is less promising. China's economy benefitted unilaterally from a spectacular 50% increase in exports to the US, an unsustainable trend. *As US consumer spending shifts from goods to services, US import demand will weaken, depriving China of a major growth engine for GDP and for its manufacturing sector*.

- *Strength in export trade and manufacturing was offset by profound weakness in consumer spending and real estate investment*, which account for 35% and 25% of GDP, respectively. Retail sales increased by a meager 1.5% in December and only 3.5% annualized over the past two years, well below the 8% growth trend of the period prior to the pandemic. Domestic demand should continue to weaken over the course of 2022.

- *Of greatest concern is China's overbuilt and highly leveraged real estate sector*. Property developers have entered a multi-year deleveraging phase as policymakers attempt to limit financial risks associated with a highly speculative and debt-ridden real estate market. Real estate investment has been a major engine of Chinese growth for many years but is currently in a downtrend that could persist throughout this year, at a minimum.

- *Profound weakness in real estate would have significant ripple effects across the Chinese economy*. A slump in new construction would result in layoffs in the housing, real estate services, and related manufacturing industries, triggering a rise in unemployment. *Declining property values would accentuate the weakness in private consumption, as anxious households increase precautionary savings*. Local governments rely on land sales and taxes for 40% of revenue, implying cutbacks in spending on infrastructure.

- *Most concerning is the rising risk of a Chinese debt crisis and financial meltdown*. Developers must contend with both a liquidity crisis and a prolonged period of balance sheet deleveraging that could culminate in a steep rise in defaults on overseas dollar-denominated bonds and loan losses in domestic banks. Nonperforming loans to the real estate sector are increasing at a startling rate. Total Chinese debt has increased from a moderate 200% of GDP in 2012 to more than 325% of GDP currently.

- *Both the Chinese government and most private forecasters are predicting GDP growth this year of 5%, a target that appears extremely unrealistic*. My forecast assumes continued weakness in private consumption and real estate construction, which comprise a combined 60% of GDP, along with weakness in business investment. Small private businesses — which form the backbone of the Chinese economy — are under enormous pressure from rapidly rising costs, slowing sales, and elevated borrowing costs from private lenders and are shutting operations at an alarming rate.

- *A growth rate in GDP of 3% seems more realistic for this year*, assuming that policymakers are able to limit contagion from the property sector to the remainder of the economy and insulate the extremely fragile financial system. Virtually every source of economic growth is under severe pressure. GDP growth of this magnitude would be the slowest since the 1980s.

- *Policymakers have begun to ease credit conditions, but monetary easing affects the economy with a time lag of six months*. The government has also increased issuance of bonds used by local governments to fund infrastructure. Tax cuts are in the works and banks have been instructed to increase lending to property developers in order to to ease liquidity pressures. However, there are practical limits to government action because of the already massive debt burden across all sectors of the economy.

- *The third major challenge for China's economy is the coronavirus pandemic and the government's zero-tolerance policy*. The combination of a highly transmissible Omicron variant and a modestly effective vaccine has resulted in a fourfold increase in new coronavirus cases, albeit from a small base. Authorities have implemented partial lockdowns and travel restrictions in order to control the pandemic in advance of the Winter Olympics in Beijing next month.

- Because some of these restrictions have been targeted toward some of China's largest port cities — Shanghai, Tianjin, and Shenzhen — *the risk of supply-chain disruptions is on the rise*. Because one-third of global manufacturing is concentrated in China, a supply-chain logjam within the country could have severe repercussions for global manufacturing.

- Prolonged economic weakness in China would impact the global economy in numerous other respects. *Because of China's role as a major importer of a full range of products, world trade would slow, and export-oriented economies would be negatively impacted*. Most important of these are exporters of machinery and industrial equipment — mainly Germany, Japan, and South Korea — and exporters of agricultural and industrial commodities, mainly Brazil, Argentina, Russia, and Indonesia. The US is a small exporter to China and would experience only minor effects.

- *Financial markets could also be impacted as China deals with its various crises*. Global equity markets could suffer as forecasts for world economic growth are downgraded, while government bond yields could be lower than otherwise, as negative news from China triggers a flight to safety. The US dollar would also strengthen in response to negative news out of China. Weakness in world commodity prices could alleviate inflationary pressures, thereby allowing central banks to tighten less aggressively than current expectations. In short, China is likely to be the source of heightened financial market volatility, evident in the equity, bond, commodity, and currency markets.

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Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

MSCI World Excluding US Equity Index: is a stock market index comprising of non-U.S. stocks from 23 developed markets and 26 emerging markets. The index is calculated with a methodology that focuses on liquidity, investability, and replicability.

NASDAQ: is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

NYSE FANG+ Index: is an equal-dollar weighted index designed to represent a segment of the technology and consumer discretionary sectors consisting of highly-traded stocks of technology and tech-enabled companies.

Russell 2000 Index: is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

Russell 3000 Value Index: : is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

The Value Line Geometric Composite Index: is the original index released, and launched on June 30, 1961. It is an equally weighted index using a geometric average. Because it is based on a geometric average the daily change is closest to the median stock price change.

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